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RE THE ARIZONA CORPORATION COMMISSION

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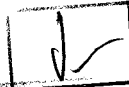
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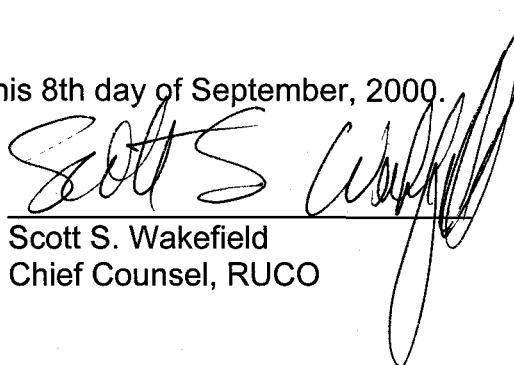
Docket No. T-01051B-99-0105

IN THE MATTER OF THE APPLICATION
OF U S WEST COMMUNICATIONS, INC.,
A COLORADO CORPORATION, FOR A
HEARING TO DETERMINE THE
EARNINGS OF THE COMPANY, THE
FAIR VALUE OF THE COMPANY FOR
RATEMAKING PURPOSES, TO FIX A
JUST AND REASONABLE RATE OF
RETURN THEREON AND TO APPROVE
RATE SCHEDULES DESIGNED TO
DEVELOP SUCH RETURN.

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the
Surrebuttal Testimony of Hugh Larkin, Jr., Ralph Smith, Dr. John Legler and Dr. Ben Johnson,
in the above-referenced matter.

RESPECTFULLY SUBMITTED this 8th day of September, 2000.


Scott S. Wakefield
Chief Counsel, RUCO

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of the foregoing filed this 8th day of
August, 2000 with:

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Recommended Revenue Changes

Comparison to US WEST Proposed Revenue Changes

This schedule contains proprietary information

**BEFORE THE
ARIZONA CORPORATION COMMISSION**

U. S. WEST COMMUNICATIONS, INC.

Docket No. T-1051B-99-105

SURREBUTTAL TESTIMONY

OF

**LARKIN & ASSOCIATES
RALPH C. SMITH**

ON BEHALF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

**Phoenix, Arizona
September 2000**

SURREBUTTAL TESTIMONY OF RALPH C. SMITH
TABLE OF CONTENTS

I. INTRODUCTION.....	1
II. TEST YEAR	3
III. RECOMMENDED ADJUSTMENTS.....	8
Non-Labor Expense Annualization.....	8
Remove Pension Asset from Rate Base	10
Software Capitalization (SOP 98-1).....	18
Service Quality Plan.....	22
Sharing of Gain on Sale of 38 Arizona Exchanges with Traffic.....	25
Adjustment to Intrastate Depreciation Expense	26
Cash Working Capital	26
Interest Synchronization.....	29
IV. SUPPLEMENTAL DIRECT TESTIMONY.....	29
Reciprocal Compensation Revenue and Expense	30
FCC Deregulated/ACC Regulated Products	34
Broadband Cable TV	36
V. UPDATED INTRASTATE REVENUE REQUIREMENT CALCULATIONS	40

Attachments:

Attachment RCS-S1 (5 pages)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Ralph C. Smith. My business address is: Larkin & Associates, 15728 Farmington Road, Livonia, Michigan 48154.

Q. ARE YOU THE SAME RALPH C. SMITH WHO PREVIOUSLY SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING ON BEHALF OF RUCO?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony on behalf of the Arizona Residential Utility Consumer Office (RUCO) is to respond to certain issues presented in the rebuttal testimony of Qwest Corporation, the regulated telecommunications subsidiary of Qwest Communications International, Inc. Qwest Corporation is the new name of the former U S West Communications, Inc. Consequently, in my surrebuttal testimony, I will refer to U S West Communications, Inc. (USWC) as Qwest or the Company on a current or forward-looking basis. When referring to prior rate cases and past events, I generally refer to the regulated telephone operation as USWC.

Q. WHAT ISSUES ARE ADDRESSED IN YOUR SURREBUTTAL TESTIMONY?

A. I am addressing certain issues concerning rate base, net operating income, and adjustment summaries on behalf of RUCO in this proceeding. Hugh Larkin, Jr., of Larkin &

1 Associates is also presenting surrebuttal testimony to address Qwest's rebuttal to a
2 number of recommended adjustments on behalf of RUCO in this proceeding.
3
4

5 Q. IN YOUR DIRECT TESTIMONY, YOU MENTIONED THAT THE COMPANY AND
6 RUCO REACHED A POTENTIAL REMEDY FOR ALLOWING RUCO TO
7 ADDRESS OTHER ISSUES, FOR WHICH LARKIN & ASSOCIATES HAD NOT
8 COMPLETED ITS ANALYSIS OR QUANTIFICATION AS OF THE TIME THE
9 DIRECT TESTIMONY WAS SUBMITTED. DO YOU RECALL THAT?

10 A. Yes. In my direct testimony I mentioned that I was advised by RUCO counsel that US
11 West and RUCO agreed that RUCO may submit with its surrebuttal testimony additional
12 adjustments and testimony resulting from the completion of the analysis of USWC's
13 (now Qwest's) 1999 test year filing. I noted that our ability to analyze issues is heavily
14 dependent upon receiving responsive answers from USWC in response to discovery.

15
16 Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?

17 A. The remainder of my testimony is organized in the following manner. I first respond to
18 Qwest's attempt to essentially convert the test year concept into a "test month." I then
19 respond to Qwest's rebuttal concerning specific adjustments I am sponsoring on behalf of
20 RUCO. I address three issues for which our analysis had not been completed as of the
21 time our direct testimony on behalf of RUCO was written. Finally, I identify the specific
22 schedules that are being provided in Exhibit ____ (L&A-2), which is being filed with
23 RUCO's surrebuttal.
24

1 Q. WHAT AMOUNT OF REVENUE SUFFICIENCY DO YOU SHOW FOR QWEST'S
2 ARIZONA INTRASTATE REVENUE REQUIREMENT?

3 A. As shown on Schedule A Revised, included with this surrebuttal, the revenue sufficiency
4 for Qwest's Arizona intrastate revenue requirement is \$34.1 million. This indicates that a
5 rate reduction amounting to \$34.1 million of intrastate revenue is warranted.

6 II. TEST YEAR

7 Q. WHAT TEST YEAR HAS BEEN USED ON BEHALF OF RUCO FOR COMPUTING
8 THE INTRASTATE REVENUE REQUIREMENT FOR QWEST IN THIS
9 PROCEEDING?

10 A. The test year that we have used on behalf of RUCO for computing the intrastate revenue
11 requirement for Qwest in this proceeding is the calendar year 1999, adjusted for known
12 and measurable changes and for disallowances of certain expenses that should not be
13 charged to ratepayers.

14
15 Q. QWEST WITNESS REDDING'S REBUTTAL TESTIMONY ON PAGES 4 AND 5
16 QUOTES FROM CERTAIN TEXTS REGARDING THE CONCEPT OF A "TEST
17 PERIOD." PLEASE COMMENT.

18 A. On pages 2 through 4 of his rebuttal, Mr. Redding mentions the term "test period"
19 numerous times. However, nothing he says would render this Commission's traditional
20 use of a test year inapplicable. To the best of my understanding, the Arizona Corporation
21 Commission has traditionally used a test year (i.e., a full twelve month period) as the
22 basis for determining the utility's revenue requirement. In the instant proceeding, Qwest
23 proposes a year-end annualization for non-labor expenses and other items. In the prior

1 USWC rate case, this Commission did not use across-the-board annualizations based on
2 the last month of the test year for items such as non-labor expense. Such blanket
3 annualizations are improper and would essentially result in converting the 1999 test year
4 into a December 1999 test month. The Commission should reject Qwest's attempt to
5 scrap the use of a test year and replace it with a "test month" as the basis for determining
6 the revenue requirement.
7

8 Q. DOES THE RESTATEMENT OF TEST YEAR NON-LABOR EXPENSE RESULT IN
9 CONDITIONS THAT ARE NECESSARILY REFLECTIVE OF CONDITIONS WHEN
10 NEW RATES ARE EXPECTED TO BE IN EFFECT?

11 A. No. Making specific pro forma adjustments for known and measurable changes is the
12 process designed to address this. However, annualizing all non-labor expenses merely
13 results in a distortion to the recorded test year expenses. Specific known and measurable
14 changes are reflected to the test year to make the recorded results better reflect known
15 conditions. However, this does not mean that items such as non-labor expenses in the
16 last month of the test year should replace the actual recorded expenses in the full twelve
17 month period constituting the test year. The Company has failed to demonstrate that the
18 test year recorded non-labor expenses are unrepresentative of normal conditions and
19 require an across-the-board adjustment. The Commission should reject Qwest's
20 inappropriate attempt at converting the 1999 test year into a December 1999 test month.
21 The Company's proposed non-labor expense annualization should be rejected.
22

1 Q. DO THE PASSAGES QUOTED ON PAGES 7 AND 8 OF QWEST WITNESS
2 REDDING'S REBUTTAL SUPPORT THE COMPANY'S PROPOSED NON-LABOR
3 ANNUALIZATION ADJUSTMENT?

4 A. No, they do not. The statements quoted by Mr. Redding on pages 7 and 8 of his rebuttal
5 merely describe the selection of the test year, "which is usually the latest 12 months for
6 which there are complete data" and the well-recognized need for making pro forma
7 adjustments for known and measurable changes occurring within the test year, and to a
8 limited extent after the end of the test year. (Emphasis supplied.) One of the passages
9 quoted by Mr. Redding at pages 7-8 of his rebuttal states that: "For many years,
10 commissions have adjusted test-year data for 'known changes' i.e., a change that actually
11 took place during or after the test period." This suggests that the regulatory
12 commission's own prior treatment of a particular item can be used as some guidance for
13 how the same item should be treated in subsequent regulatory proceedings. Qwest's
14 proposed blanket annualization of non-labor expense is not consistent with and goes well
15 beyond this Commission's method of adjusting test year expenses for known and
16 measurable changes.

17
18 Q. AT PAGES 8 THROUGH 10 OF HIS REBUTTAL, QWEST WITNESS REDDING
19 DESCRIBES A "TEST" HE PURPORTEDLY MADE TO "OVERLAY" THE STAFF
20 AND RUCO REVENUE REQUIREMENTS "ON 2000 ACTUAL RESULTS." DO
21 YOU AGREE WITH MR. REDDING'S ANALYSIS?

22 A. No, I do not. Mr. Redding's analysis is so severely flawed as to be essentially
23 meaningless. First, he uses May 2000 year-to-date results, annualized, as the basis for

1 his comparison of net operating income. It is not accurate to describe this as "2000 actual
2 results" because it does not reflect the full year's results for calendar year 2000. There is
3 no support for substituting five months of post-test year net operating income results for
4 the 1999 test year results. To the best of my knowledge, this Commission has generally
5 not accepted that type of blanket test year updating with post test-year results. Moreover,
6 there is no indication that Mr. Redding reflected in his year-to-date May 2000 annualized
7 results the types of adjustments that Staff and RUCO are recommending. To the extent
8 that Mr. Redding's May 2000 results fail to include similar adjustments and expense
9 disallowances to those being proposed by Staff and RUCO, he is making an "apples to
10 oranges" comparison that proves nothing.

11
12 Q. IS MR. REDDING ALSO ATTEMPTING TO IMPROPERLY INFLATE THE RATE
13 BASE IN HIS PURPORTED "TEST" OF THE REVENUE REQUIREMENT?

14 A. Yes. The presentation on page 9 of Qwest witness Redding's rebuttal attempts to use a
15 May 2000 rate base of \$1.630 billion. This is significantly higher than the \$1.421 billion
16 Arizona intrastate rate base filed by the Company using the 1999 test year. It is also
17 significantly higher than the \$1.399 billion Arizona intrastate rate base proposed in
18 RUCO's direct testimony, as shown on RUCO Exhibit ____ (L&A-1), Schedule B. Thus,
19 Mr. Redding's attempt to utilize a new higher rate base by going out five months beyond
20 the end of the 1999 test year contributes towards the distorted presentation of Staff and
21 RUCO results on page 9 of his rebuttal.

22

1 Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THE "RESULTS OF THE
2 TEST" PRESENTED BY MR. REDDING AT PAGE 9 OF HIS REBUTTAL?

3 A. Yes. As explained above, Qwest witness Redding's purported "test" presented on page 9
4 of his rebuttal is so severely flawed it cannot be relied upon for any conclusions
5 regarding whether the Staff and RUCO revenue requirement recommendations are
6 appropriate. However, Mr. Redding's presentation shows in the "Qwest" column that the
7 Company's calculated revenue deficiency would produce a return on average investment
8 of 11.04%,. This exceeds even Qwest's own recommended rate of return,. Thus, even by
9 the standards of Mr. Redding's purported "test," the Company's calculated revenue
10 deficiency is overstated.

11
12 Q. YOU MENTIONED THAT BECAUSE OF ITS SEVERE FLAWS, THE
13 PRESENTATION ON PAGE 9 OF QWEST WITNESS REDDING'S REBUTTAL
14 TESTIMONY DOES NOT LEAD TO ANY RELIABLE CONCLUSIONS
15 REGARDING THE APPROPRIATENESS OF RUCO'S RECOMMENDED REVENUE
16 REQUIREMENT. WHERE SHOULD ONE LOOK WHEN EVALUATING THE
17 APPROPRIATENESS OF RUCO'S PROPOSED REVENUE REQUIREMENT?

18 A. When evaluating the appropriateness of RUCO's proposed revenue requirement, one
19 should look at Exhibit ____ (L&A-1) of RUCO's direct testimony and the update of that
20 filed with RUCO's surrebuttal. These exhibits contain the schedules which show in
21 detail the development of RUCO's recommended rate base, adjusted net operating
22 income, rate of return, and the resultant calculation of the total change in the revenue
23 requirement. As shown on Schedule A, for example, the revenues recommended on

1 behalf of RUCO are sufficient to produce RUCO's recommended rate of return on the
2 adjusted rate base, using RUCO's adjusted net operating income.

3
4 Q. AT PAGE 10, LINES 16-18, OF QWEST WITNESS REDDING'S REBUTTAL, HE
5 INDICATES THAT, IN HIS OPINION, STAFF AND RUCO "ENGAGED IN A
6 FAIRLY RIGOROUS DEVELOPMENT OF A REVENUE REQUIREMENT OR
7 DEFICIENCY" AND SUGGESTS THAT THE "MUCH MORE GENERALIZED
8 APPROACH" HE ATTRIBUTES TO DOD/FEA AND AT&T "SHOULD BE
9 ACCORDED LESS WEIGHT THAN STAFF & RUCO." PLEASE COMMENT ON
10 THIS OBSERVATION, IN VIEW OF THE "REVENUE REQUIREMENTS TEST"
11 PRESENTATION SHOWN ON PAGE 9 OF MR. REDDING'S REBUTTAL.

12 A. The presentation on page 9 of Qwest witness Redding's rebuttal does not even rise to the
13 level of a "much more generalized approach" that he attributes to DOE/FEA and AT&T.
14 Accordingly, applying Mr. Redding's own suggestion on page 10 of his rebuttal, the
15 presentation on page 9 of Qwest witness Redding's rebuttal should be accorded less
16 weight than the presentations of any of the parties mentioned on his page 10, lines 16-20.

17 **III. RECOMMENDED ADJUSTMENTS**

18 ***Non-Labor Expense Annualization***

19 Q. PAGES 13-18 OF QWEST WITNESS REDDING'S REBUTTAL TESTIMONY
20 ADDRESS THE COMPANY'S PROPOSED NON-LABOR EXPENSE
21 ANNUALIZATION ADJUSTMENT. DOES THAT TESTIMONY CONVINCING YOU
22 THAT THE COMPANY'S PROPOSED NON-LABOR ADJUSTMENT IS
23 APPROPRIATE AND SHOULD BE MADE?

1 A. No, it does not. A blanket annualization of non-labor expense, as proposed by Qwest, is
2 not consistent with past Commission practice. Moreover, the analysis presented by Mr.
3 Redding in his rebuttal is flawed. Consequently, the Company's proposed non-labor
4 expense annualization adjustment should be rejected.

5
6 Q. HAVE YOU ACCEPTED SOME OF THE COMPONENTS OF U S WEST'S
7 PROPOSED ANNUALIZATION ADJUSTMENTS?

8 A. Yes, as explained in my direct testimony, I have accepted USWC's annualization of
9 deregulated revenue, wages and benefits expense, property taxes, rent compensation, and
10 uncollectibles. Additionally, I agree with the concept of adjusting test year revenues,
11 where appropriate, for known changes. As described in the direct testimony of RUCO
12 witness Larkin, there are a number of concerns regarding U S WEST's derivation of its
13 revenue annualization adjustment. In his direct testimony, RUCO witness Larkin
14 discussed an alternative revenue annualization adjustment which better reflects known
15 changes and a normal, ongoing level of operations than U S WEST's proposed
16 adjustment does. On Exhibit E-1, filed with RUCO's direct testimony, I removed the
17 component of U S WEST's adjustment that addresses revenue annualization.
18 Additionally, in my opinion, the portion of U S WEST's adjustment which attempts to
19 apply a blanket annualization of non-labor expense is not appropriate and is not
20 consistent with past regulatory practice of this Commission. Therefore, I have also
21 removed U S WEST's proposed non-labor adjustment. In the direct and surrebuttal
22 testimony submitted on behalf of RUCO Mr. Larkin and I discuss adjustments to a
23 number of specific expenses for known changes and/or recommended disallowances.

1 This approach is consistent with Commission practice, whereas applying a blanket
2 annualization of non-labor expenses as proposed by Qwest, is not.

3
4 Q. AT PAGE 14, LINES 17-19, OF HIS REBUTTAL, QWEST WITNESS REDDING
5 STATES: "I WILL COMPARE THE COMPANY'S ANNUALIZATIONS SIDE BY
6 SIDE WITH THE RESULTS OF STAFF AND RUCO AGAINST THE LEVEL OF
7 ACTUAL RESULTS FOR THE YEAR 2000. THIS IS THE TRUE TEST OF THE
8 ADJUSTED TEST PERIOD LEVELS OF REVENUES AND EXPENSES." PLEASE
9 RESPOND.

10 A. First, the actual results for the year 2000 are not yet known. Consequently, at this time,
11 Mr. Redding cannot be comparing anything to the actual results for the full year 2000. He
12 has only attempted to make a comparison using the first few months of 2000. Moreover,
13 without analyzing in detail what the Company actually recorded in those months, one
14 does not know if those months are representative of normal operating conditions.
15 Typically, months outside the test year would not be analyzed in such detail because this
16 Commission has traditionally not adopted adjustments after the test year, unless there has
17 been a compelling reason to do so.

18 ***Remove Pension Asset from Rate Base***

19 Q. THE REBUTTAL TESTIMONY OF QWEST WITNESS GRATE, AT PAGE 46,
20 CHARACTERIZES THE PENSION ASSET RESULTING FROM THE FORMER US
21 WEST'S OVERFUNDED PENSION PLAN AS A "PRIMARY COMPONENT THAT
22 MUST BE CONSIDERED FOR INCLUSION IN RATE BASE." DO YOU AGREE
23 WITH THAT CHARACTERIZATION OF THE PENSION ASSET?

1 A. No. Qwest has attempted to include \$66.221 million in rate base for a pension asset.

2 However, this asset has not been funded by shareholders and does not belong in rate base.

3 The pension asset is not a "primary component" of rate base. It does not belong in rate
4 base at all.

5
6 Q. AT PAGE 42 OF HIS REBUTTAL, QWEST WITNESS GRATE CLAIMS THAT THE
7 PENSION ASSET HAS BEEN FUND "FUNDED" BY QWEST'S INVESTORS IN
8 THE FORM OF DEBT AND EQUITY ON QWEST'S BOOKS. PLEASE RESPOND.

9 A. Mr. Grate apparently fails to recognize that a portion of the pension asset is related to an
10 amount of Accumulated Deferred Income Taxes (ADIT), which is a deferred credit on
11 the books of the former USWC (now Qwest). Moreover, merely pointing to the fact that
12 USWC had, and Qwest has debt and equity on its books, is insufficient to demonstrate
13 that investors have advanced excess pension amounts.

14
15 Q. WAS THIS SAME ISSUE ADDRESSED IN U S WEST'S PRIOR RATE CASE?

16 A. Yes, it was. In U S WEST's last Arizona rate case, Docket No. E-1051-93-183, the
17 Commission issued Decision No. 58927. In that decision, the Commission denied U S
18 WEST's request to include the net amount of the Company's pension asset in rate base.

19 At page 5 of that decision, the Commission stated specifically that:

20 ... we find the Company has not presented sufficient evidence to clearly
21 demonstrate that its shareholders have advanced the excess pension amounts.
22 Accordingly, we must deny the Company's request to include the net amount of
23 overfunding of \$36,213,000 in rate base.
24

1 Q. IS QWEST ATTEMPTING IN THE INSTANT PROCEEDING TO RE-LITIGATE
2 THE DECISION CONCERNING THE PENSION ASSET MADE BY THE
3 COMMISSION IN THE PRIOR US WEST RATE CASE?

4 A. It certainly appears so. Page 53, lines 20-21, of Qwest witness Grate's rebuttal states
5 that: "Qwest respectfully disagrees with the conclusion the Commission reached in the
6 prior order." Thus, the Company is attempting in the current proceeding to re-litigate this
7 issue, which it lost in the prior US WEST rate case.

8
9 Q. WHAT NEW AND DIFFERENT EVIDENCE HAS QWEST PRESENTED IN THE
10 INSTANT CASE IN SUPPORT OF ITS ATTEMPTED RE-LITIGATION OF THIS
11 ISSUE?

12 A. None. It is the same issue and the same arguments that the Company presented in the
13 prior USWC rate case. The Commission made the correct decision in that case, and there
14 is nothing new or different in the current case that would require a change. The pension
15 asset should be excluded from rate base in the instant case, just as it was in the prior
16 USWC rate case.

17
18 Q. CONCERNING ITS RATE BASE CLAIM FOR A PENSION ASSET, WHAT
19 EVIDENCE, IF ANY, IS THE COMPANY RELYING UPON THAT THE OVER-
20 FUNDED BALANCE WAS PROVIDED BY SHAREHOLDERS?

21 A. None. Data Request RUCO-9-1 asked the Company to provide such information. In
22 response, the Company stated that: "In claiming that rate base should include the pension
23 asset, the Company is relying upon its balance sheet upon which the pension asset

1 appears. The balance sheet shows that the pension asset is funded by investor supplied
2 capital in the form of debt and shareholders' capital."

3 However, the fact that a pension asset is on the balance sheet now is nothing new,
4 and does not clearly demonstrate that the over funded pension balance was funded by
5 shareholders. Moreover, the Commission has typically used lead-lag studies to determine
6 cash working capital in rate base, and has not typically used balance sheet amounts for
7 items such as pensions.
8

9 Q. IF THE OVER-FUNDED PENSION BALANCE WAS NOT FUNDED BY
10 SHAREHOLDERS, BY WHOM WAS IT FUNDED?

11 A. The over funded pension balance was produced by a combination of the following
12 factors: (1) the switch to accrual accounting when Statement of Financial Accounting
13 Standards 87 (FAS 87) was adopted by the Company; (2) ratepayer payments to the
14 Company for amounts of pension expense that were reflected in rates; and (3) earnings on
15 the pension trust assets.

16 Additionally, there is an Accumulated Deferred Income Tax (ADIT) balance
17 associated with the pension asset. The ADIT balance is a deferred credit on the balance
18 sheet.
19

20 Q. HAS U S WEST OR QWEST CONTRIBUTED MONEY INTO THE PENSION PLAN
21 SINCE IT ADOPTED FAS 87?

22 A. No. No contributions have been made to the qualified pension plan by or on behalf of
23 USWC since the adoption of FAS 87. In other words, the Company has not contributed

1 any funding into the qualified pension plan trust for many years, and has not contributed
2 any since its last Arizona rate case.

3
4 Q. HOW ABOUT THE PERIOD 1994 THROUGH 1998, DID THE COMPANY MAKE
5 ANY FUNDING CONTRIBUTIONS TO ITS QUALIFIED PENSION PLAN DURING
6 THIS PERIOD?

7 A. No. The Company's response to Data Request RUCO-2-8 indicates that, due to the
8 previous funding and earnings growth on the Pension Trust, the Company did not have a
9 requirement to fund the Pension Trust for the years 1994 through 1998, and no funding
10 contributions were made to the Pension Trust for those years. The Company's response
11 to RUCO-2-8 states further that: "Nothing has been collected in rates for pension
12 expense in the years 1994 through 1998." This response was not updated by USWC in
13 conjunction with its 1999 test year filing; however, given the vastly over-funded status of
14 the qualified pension plan, it is unlikely that USWC made any funding payments in 1999
15 either. Thus, the fund has grown during this period due to earnings on the pension trust
16 assets, and not from any contributions from the Company's shareholders.

17
18 Q. WHAT RETURNS HAVE THE ASSETS IN THE QUALIFIED PENSION TRUST
19 EARNED IN RECENT YEARS?

20 A. The Company's response to Data Request UTI-20-7 listed the annual earnings return
21 achieved by the pension fund for each year, 1987 through 1998. That information shows
22 that the returns have generally been quite good. Moreover, U S WEST's response to Data
23 Request UTI-20-7, part b, indicates that the primary factor causing the pension credits is

1 the return on plan assets. In other words, the high returns earned on pension plan assets
2 have contributed to the growing over funded status of the qualified pension plan.
3

4 Q. SHOULD THE PENSION ASSET BE INCLUDED IN RATE BASE?

5 A. No, it should not. The Commission's decision in the prior USWC rate case rejected rate
6 base inclusion for the pension asset. In the instant case, the Company has presented no
7 new or different arguments. In the instant case, just like in the prior USWC rate case, the
8 Company has not clearly demonstrated that the pension asset had been funded by
9 shareholders. Therefore, the pension asset should be removed from rate base.
10

11 Q. PAGE 54 OF THE REBUTTAL TESTIMONY OF QWEST WITNESS GRATE
12 CONTAINS TWO NEW RECOMMENDATIONS FROM THE COMPANY: (1)
13 ENSURE THAT NO FURTHER PENSION ASSET IS CREATED BY CEASING ANY
14 FURTHER RECOGNITION OF NEGATIVE PENSION EXPENSE IN REGULATED
15 RESULTS OF OPERATIONS AND COST OF SERVICE, AND (2) RETURN THE
16 PENSION ASSET TO INVESTORS BY AMORTIZING IT INTO COST OF SERVICE
17 OVER AN APPROPRIATE AMORTIZATION PERIOD. DO YOU AGREE WITH
18 EITHER OF THESE NEW RECOMMENDATIONS BY THE COMPANY?

19 A. No, I strongly disagree with each of these new Company recommendations. The
20 negative pension expense reflected in the 1999 test year resulting from the funding
21 surplus and the application of generally accepted accounting principles (GAAP) such as
22 FAS 87 should be included in the operating results. In the recent Qwest/US West merger
23 proceeding, the Commission stated that it will take into account the surplus in the pension

1 trust fund in the current USWC rate case in establishing the on-going amounts to be paid
2 by ratepayers. Ratepayers should receive the benefit of the lower pension expense
3 resulting from the Commission's adoption of FAS 87 for ratemaking purposes.
4 Moreover, this benefit should not be reduced or negated by the imposition of a return
5 requirement for an improper rate base item, as the Company has attempted in the prior
6 USWC rate case and again in the current rate case.

7 Including the pension asset in rate base is not only improper, but doing so would
8 also largely negate the benefit to ratepayers from the negative pension expense resulting
9 from the Commission's adoption of FAS 87.

10 The Company has failed to prove that the pension asset was funded by
11 shareholders; consequently, there is no basis for requiring that the pension asset be
12 "amortized into the cost of service" as Mr. Grate suggests. Moreover, such treatment
13 would be contrary to GAAP, and the application of FAS 87, which the Commission has
14 adopted for ratemaking purposes. In summary, these new proposals from Qwest are ill-
15 conceived and should be rejected.

16 These new proposals are also contradicted by some of the testimony presented on
17 behalf of the Applicants in the recent Qwest/US West merger proceeding concerning
18 pensions.

19
20 Q. PLEASE ELABORATE UPON HOW THESE NEW PROPOSALS BY THE
21 COMPANY ARE CONTRADICTED BY TESTIMONY PRESENTED BY
22 APPLICANTS IN THE RECENT QWEST/US WEST MERGER PROCEEDING.

1 A. In the Qwest/US West merger proceeding, the rebuttal testimony of Applicant witness

2 Carl Inouye stated at pages 7-8 as follows:

3 It should be noted that the accounting practice, known as FAS 87, is a
4 requirement that the Company must follow pursuant to Security and Exchange
5 Commission rules. FAS 87 has been adopted by this Commission in prior rate
6 cases.

7
8 The claim that U S WEST shareholders are benefiting through inflated earnings is
9 simply wrong. TRAA ignores that the requirement of FAS 87 to amortize the
10 pension surplus as expense credits has caused Arizona customer rates to be lower
11 than otherwise. Thus, any income effect of FAS 87, combined with ratemaking
12 by this Commission, has not boosted the company's earnings. The fact of the
13 matter is that revenue reductions achieved through ratemaking offset the pension
14 credit to expense such that the net effect on income disappears.
15

16 At page 13, lines 18-21, of that same rebuttal testimony, Applicant witness Inouye stated:

17 There is no discernible reason why the Commission's requirement for FAS 87
18 accounting rules should be re-looked at in the Arizona rate case. As I stated
19 earlier, the pension credits required under FAS 87 have had the effect of lowering
20 customer rates, but have not changed the level of pension funds.
21

22 Qwest witness Grate's new proposals in the instant rate case are inconsistent with the
23 application of FAS 87, and are directly contradicted by the above-quoted statements from
24 Applicant witness Inouye's rebuttal testimony in the recent Qwest/US West merger
25 proceeding, Docket No. T-01051B-99-0497. The two new proposals by Qwest witness
26 Grate are highly inappropriate and must be rejected.
27

28 Q. WHAT IS YOUR CONCLUSION REGARDING THE APPROPRIATE
29 RATEMAKING TREATMENT OF THE PENSION ASSET?

30 A. Consistent with the Commission's findings in the prior US West rate case, the pension
31 asset should be excluded from rate base because the Company has failed to demonstrate
32 that it was funded by shareholders. The associated amount of ADIT should also be

1 removed. RUCO Adjustment E-10, shown on Schedule E-10, filed with my direct
2 testimony, reflects the appropriate adjustment.
3

4 **Software Capitalization (SOP 98-1)**

5 Q. WHAT IS AICPA STATEMENT OF POSITION NO. 98-1?

6 A. As noted in my direct testimony, the American Institute of Certified Public Accountants
7 ("AICPA") has issued a Statement of Position ("SOP") No. 98-1 ("SOP 98-1")
8 addressing the capitalization of software costs. SOP 98-1 has become a part of generally
9 accepted accounting principles ("GAAP"). In general, SOP 98-1 requires that software
10 costs be capitalized. Prior to the adoption of SOP 98-1, many companies, including
11 USWC, had been expensing internally developed software costs, which now must be
12 capitalized in compliance with GAAP.
13

14 Q. WHAT REASONS DOES QWEST PRESENT IN ITS REBUTTAL FOR NOT
15 ADOPTING SOP 98-1 FOR RATEMAKING PURPOSES?

16 A. Qwest witness Redding's rebuttal, at page 19, states his opinion that SOP 98-1 should not
17 be adopted for intrastate ratemaking purposes because there is no change in cash flows
18 coupled with short lives. Consequently, on page 20, he advocates that the Commission
19 ignore this accounting change for ratemaking purposes.
20

21 Q. DO YOU AGREE WITH MR. REDDING'S ANALYSIS THAT THERE IS NO
22 IMPACT ON CASH FLOWS?

1 A. No. Capitalization of software costs pursuant to SOP 98-1 results in a significant
2 reduction in Qwest's revenue requirement for Arizona intrastate telephone service in the
3 current proceeding. Thus, if the Commission adopts this accounting principle for
4 ratemaking purposes, which it should, there is an significant impact on the intrastate
5 revenue requirement. The intrastate revenue requirement is lowered significantly under
6 the accounting prescribed by SOP 98-1 because USWC (now Qwest) had been expensing
7 large amounts for internally developed software, whereas SOP 98-1 requires that such
8 costs be capitalized and amortized.

9
10 Q. HAS QWEST ADOPTED SOP 98-1 FOR ACCOUNTING AND FINANCIAL
11 REPORTING PURPOSES?

12 A. Yes, for financial and book accounting purposes, Qwest has adopted SOP 98-1.
13 Qwest will be following SOP 98-1 for financial reporting purposes, but has not reflected
14 the impact of this accounting principle in its 1999 test year Arizona rate filing. This
15 substantially increases the Arizona intrastate revenue requirement because millions of
16 dollars of software cost that is now required to be capitalized, but which has been
17 reflected for Arizona ratemaking purposes by Qwest in its rate filing as a current period
18 expense. On its books, and for financial reporting purposes, Qwest is capitalizing such
19 cost and depreciating it over a five-year period.

20
21 Q. PLEASE DISCUSS THE ISSUE ASSOCIATED WITH THE "SHORT LIVES" OF
22 CAPITALIZED SOFTWARE.

1 A. US WEST's proposed treatment of software capitalization substantially increases the
2 revenue requirement in the current case by not reflecting capitalization treatment in
3 accordance with generally accepted accounting principles (GAAP). US WEST defends
4 this treatment by pointing out that the relatively short time frame for depreciating
5 software (usually five years) would cause a higher rate base, and approximately the same
6 expense levels in five years, i.e., a higher revenue requirement at that time if
7 capitalization is applied. However, in the instant rate case, we are setting rates for
8 regulated services today. Five years from now, customers may have competitive choices
9 for a variety of telephone services that exist only in very limited form today.

10
11 Q. SHOULD THE ADOPTION OF SOP 98-1 BE REFLECTED FOR RATEMAKING
12 PURPOSES?

13 A. Yes, it should. This GAAP is appropriate for ratemaking purposes. It reflects the fact
14 that software has a benefit lasting longer than a single year. It is appropriate to reflect the
15 amortization into expense of software costs over a five year period, commencing with the
16 adoption of SOP 98-1.

17
18 Q. HAVE YOU CALCULATED AN ADJUSTMENT TO REFLECT SOP 98-1 FOR
19 USWC'S ARIZONA INTRASTATE RESULTS?

20 A. Yes. This adjustment is shown on Schedule E-15, which was filed with RUCO's direct
21 testimony. Using a five-year amortization period, on Schedule E-15 I have reflected an
22 adjustment for the generally accepted accounting treatment for software costs per SOP
23 98-1 in the Arizona intrastate results for the first three years of implementing this

1 accounting change. The impact of this accounting change is greatest in the first year, so
2 using a three-year average impact for the adjustment helps smooth the transition. The
3 three year period also corresponds with the use by USWC and now Qwest of a three-year
4 revenue requirement for certain items. For example, it is the same period used by USWC
5 for the amortization of other items, such as the gain on sale of its interest in Bellcore.
6 The Company's 1999 test year filing, as reflected in Mr. Redding's exhibits filed May 3,
7 2000 reflects a column for a three-year revenue requirement. While I have not presented
8 items in a similar column, my treatment of SOP 98-1 over the initial three-year period of
9 adoption is similar to the Company's calculation and use of a three-year revenue
10 requirement for certain items.

11
12 Q. AT PAGE 23 OF HIS REBUTTAL, QWEST WITNESS REDDING CLAIMS THAT
13 AN AUTOMATIC ADJUSTMENT RIDER WOULD BE NECESSARY IF SOP 98-1
14 WAS ADOPTED FOR RATEMAKING PURPOSES. DO YOU AGREE?

15 A. No, I do not. As noted above, my adjustment for the adoption of SOP 98-1 for
16 ratemaking purposes reflects an average impact of the first three years, similar to Qwest's
17 calculation of three-year revenue requirement impacts for other items, such as the
18 recognition of the gain on the sale of its interest in Bellcore. There is no need for an
19 automatic adjustment mechanism for ratemaking adjustments to reflect generally
20 accepted accounting principles. I note that Qwest is not proposing that a similar
21 automatic adjustment mechanism be implemented for decreases in pension expense
22 occurring between rate cases as the result of applying the provisions of FAS 87. There is

1 no need for an automatic adjustment mechanism associated with the adoption of SOP 98-
2 1 for ratemaking purposes.

3
4 Q. WHAT WILL HAPPEN AFTER THREE YEARS UNDER YOUR PROPOSAL
5 CONCERNING SOP 98-1?

6 A. Over a three-year period, Qwest's investment, revenue and expense will change.
7 Accordingly, Qwest will have to review all items that contribute to its Arizona intrastate
8 revenue requirements and determine if an Arizona intrastate rate filing is necessary at that
9 time. There is no need to carve out one or two areas where costs could increase in the
10 future for automatic adjustment mechanisms, when other items such as pension expense,
11 computed pursuant to FAS 87 may be decreasing, and other cost savings may be realized
12 as the result of work force downsizing and consolidation or operations after the
13 Qwest/US West merger.

14
15 **Service Quality Plan**

16 Q. WHAT IS THE COMPANY'S "SERVICE QUALITY PLAN"?

17 A. As described in my direct testimony, the Company's Service Quality Plan was
18 established in a prior USWC regulatory proceeding and is part of the Company's tariff in
19 Arizona. It contains measures, such as penalties, to be paid by the Company to the
20 Commission if the Company fails to meet service quality standards. It also requires the
21 Company to pay for cellular phones, call forwarding, etc., when it cannot meet acceptable
22 service standards, including timely installation of new services and repair of out-of-
23 service conditions.

24

1 Q. AT PAGES 40-41 OF HIS REBUTTAL TESTIMONY, QWEST WITNESS REDDING
2 ATTEMPTS TO JUSTIFY CHARGING CUSTOMERS FOR SUCH COSTS
3 "BECAUSE THEY ARE A REASONABLE COST OF DOING BUSINESS, AND
4 BECAUSE QWEST IS INDEED PROVIDING SERVICE TO THE CUSTOMER,
5 EVEN IF IT IS NOT THE PRECISE SERVICE THE CUSTOMER HAS
6 REQUESTED." (REDDING REBUTTAL, PAGE 41, LINES 3-5.) SHOULD SUCH
7 COSTS BE CHARGED TO CUSTOMERS?

8 A. No. The cost incurred by Qwest associated with the failure to meet acceptable service
9 quality standards should not be charged to customers. Ratepayers should not be forced to
10 pay extra when the Company fails to meet minimum acceptable service quality standards.
11 Ratepayers should not bear the extra cost incurred by the Company for cellular vouchers,
12 paging vouchers or other accrued expenses under its Service Quality Plan that relate to its
13 failure to meet minimum acceptable service quality standards. Consequently, the excess
14 cost incurred during the test year under the Service Quality Plan associated with the
15 Company's failure to meet minimum acceptable service quality standards should be
16 disallowed. Shareholders, not ratepayers, should bear such cost.

17 At page 41, lines 9-11 of his rebuttal, Mr. Redding asserts that alternative services
18 including paging vouchers, remote call forwarding, and voice messaging are quite similar
19 to traditional services, and Qwest provides such alternative services "at no cost to the
20 customer." That is just the point. When Qwest fails to meet the established quality of
21 service standards, as specified in its Service Quality Tariff, it must provide such
22 alternative services at no cost to the customer. RUCO's adjustment for Service Quality
23 Plan expenses assures that there is no cost being charged to the customer for such

1 alternative services, which are required under the Service Quality Plan, when the
2 Company cannot meet the minimum service quality standards.

3
4 Q. DO YOU HAVE ANY OTHER CONCERNS REGARDING THE COMPANY'S
5 ATTEMPT TO CHARGE RATEPAYERS FOR THE COSTS IT INCURS
6 ASSOCIATED WITH ITS FAILURE TO MEET ARIZONA SERVICE QUALITY
7 STANDARDS?

8 A. Yes. Company management determines the level of Company resources to be devoted to
9 meeting service quality standards. If the cost of non-compliance with service quality
10 standards is borne by ratepayers, this would inappropriately remove the economic
11 responsibility from the Company for its decisions regarding service quality compliance
12 efforts, where such decisions lead to non-compliance situations. In recent years, USWC
13 has failed to provide service that meets the minimum standards established by the
14 Commission. As evidenced by the Service Quality Forum conducted by this
15 Commission, and by the significant efforts devoted to addressing USWC service quality
16 concerns in the Qwest/US West merger proceedings before this Commission and the
17 regulatory commissions in a number of other USWC states, substantial regulatory
18 difficulties have been encountered in getting US West to comply with service quality
19 standards, particularly in the areas of timely installation of new service and prompt repair
20 of out-of-service conditions.

21 Requiring ratepayers to bear costs associated with the Company's service quality
22 failures -- as Qwest is advocating -- would have the undesirable result of removing a
23 substantial incentive to Qwest for achieving compliance with the Arizona quality of

1 service standards set forth in the Company's Service Quality Plan tariff. If the costs
2 imposed by the Commission on the Company for failure to meet service standards are
3 passed on to ratepayers as just another "cost of doing business," this would remove an
4 important economic incentive to Qwest for meeting the established Arizona service
5 quality standards. By requiring that costs for failure to provide adequate service quality
6 be borne by shareholders, and prohibiting the passing on of such costs to ratepayers, the
7 Commission keeps the responsibility to meet service quality standards where it belongs –
8 on the Company.

9 ***Sharing of Gain on Sale of 38 Arizona Exchanges with Traffic***

10 Q. AT PAGE 31 OF HIS REBUTTAL, QWEST WITNESS REDDING ASSERTS THAT
11 YOU PROPOSE TO INAPPROPRIATELY ADDRESS THE DISPOSITION OF THE
12 GAIN THE COMPANY IS REALIZING ON THE SALE OF ARIZONA EXCHANGES
13 WITH TRAFFIC IN THIS CASE, RATHER THAN IN THE ACCESS LINE SALE
14 DOCKET. PLEASE RESPOND.

15 A. Contrary to Mr. Redding's assertion, it is not inappropriate to reflect the quantification of
16 RUCO's recommendation in the concurrent proceeding addressing the sale of 38
17 exchanges, with traffic, Docket No. T-01051B-99-0737, in terms of its impact on the
18 instant Qwest Arizona rate case. As I stated in my direct testimony:

19 This adjustment is shown on Schedule E-22 and reflects the sharing of the
20 estimated after-tax gain anticipated to be realized by USWC on the sale of 38
21 Arizona exchanges with traffic to Citizens Communications. The Commission is
22 addressing the transaction in a concurrent proceeding, Docket No. T-01051B-99-
23 0737. The sharing of the gain between shareholders and ratepayers is consistent
24 with RUCO's position in the sale proceeding, as discussed in the testimony of
25 RUCO witness Marylee Diaz Cortez. On Schedule E-22, I have reflected the
26 sharing of the gain over a three-year period. Three years is the same period used
27 by USWC to reflect the sharing with ratepayers of 50% of the gain it realized
28 upon the sale of its interest in Bellcore.

1
2 I was asked by RUCO to reflect in the instant rate case the impact of RUCO's position in
3 the concurrent proceeding, Docket No. T-01051B-99-0737, that the gain on the sale of
4 the 38 Arizona exchanges, with traffic, be shared between shareholders and ratepayers,
5 and have done so on Schedule E-22, which was filed with my direct testimony. This
6 treatment, including the sharing of the gain over a three-year period, is similar to and
7 consistent with the Company's reflection of the sharing with ratepayers of 50% of the
8 gain it realized upon the sale of its interest in Bellcore and is consistent with prior
9 Commission precedent, as discussed at length in RUCO's testimony in Docket No. T-
10 01051B-99-0737.
11

12 ***Adjustment to Intrastate Depreciation Expense***

13 Q. ON SCHEDULE E-8, FILED WITH YOUR DIRECT TESTIMONY, YOU HAD
14 MADE AN ADJUSTMENT TO CORRECT THE AMOUNT OF TEST YEAR
15 DEPRECIATION FOR THE IMPACT OF THE COMPANY'S SALE OF 38 ARIZONA
16 EXCHANGES, WITH TRAFFIC. HAS THE COMPANY ADDRESSED THIS ISSUE
17 IN ITS REBUTTAL TESTIMONY?

18 A. Yes. On pages 34-35 of his rebuttal testimony, in addressing a Staff adjustment for
19 depreciation expense related to the sale of these Arizona exchanges, Qwest witness
20 Redding agrees in principle that such an adjustment should be made.
21

22 ***Cash Working Capital***

23 Q. PAGE 42 OF QWEST WITNESS REDDING'S REBUTTAL TESTIMONY STATES
24 THAT YOUR CASH WORKING CAPITAL ADJUSTMENT IS BASED ON THE

1 TEST YEAR ENDED JUNE 30, 1998, RATHER THAN THE UPDATED TEST YEAR
2 OF CALENDAR 1999 AND SHOULD BE DISREGARDED. PLEASE RESPOND.

3 A. The correct amount of intrastate rate base allowance for cash working capital for the test
4 year ending December 31, 1999 is negative \$46.232 million, according to the
5 documentation provided by the Company in response to a number of data requests. On
6 RUCO Exhibit ___(L&A-1), Schedule B, line 4, filed with my direct testimony, I had
7 only reflected a rate base deduction for cash working capital in the amount of \$45.020
8 million. Consequently, an adjustment to decrease the rate base amount shown on
9 Schedule B by \$1.212 million (\$46.232 million less \$45.020 million) is necessary. With
10 my surrebuttal testimony, I am including a revised Schedule E-24 showing the
11 appropriate adjustment.

12
13 Q. DID THE COMPANY STATE IN RESPONSE TO DATA REQUESTS THAT IT WAS
14 NOT UPDATING THE JUNE 30, 1998 CASH WORKING CAPITAL AMOUNT?

15 A. Yes. The response to Data Request RUCO-28-6(a) stated that the Company confirms
16 that the \$41.772 million negative amount for cash working capital for the test year ending
17 June 30, 1998 is not being updated. The Company's response to Data Request UTI-43-
18 14 stated that: "U S WEST did not conduct a new lead-lag study in connection with the
19 update test year." These responses by the Company may not have been totally accurate
20 in describing whether the Company had or had not updated the cash working capital
21 allowance amount for the test year ending December 31, 1999. However, other responses
22 from the Company clearly indicate that the negative \$46.232 million is the correct

1 amount of intrastate cash working capital allowance for use with the December 31, 1999
2 test year.

3
4 Q. PLEASE DISCUSS THE RESPONSES WHICH ESTABLISH THAT THE NEGATIVE
5 \$46.232 MILLION IS THE CORRECT AMOUNT OF INTRASTATE CASH
6 WORKING CAPITAL ALLOWANCE FOR USE WITH THE DECEMBER 31, 1999
7 TEST YEAR.

8 A. The responses are included in Attachment RCS-S1 to my surrebuttal testimony. The first
9 two pages are from the response to Data Request UTI-42-1. The first page, at line 33
10 shows the calculation of the Commission Basis Cash Working Capital amount for the
11 Company's Arizona intrastate operations for the test year ending December 31, 1999 to
12 be negative \$46.232 million. The second page, at line 19, shows this same amount.
13 Page 3 of Attachment RCS-S1 shows the Company's response to Data Request RUCO-
14 28-6. Part b of that request had asked the Company to "explain why the Commission
15 Basis Cash Working Capital amount on line 19 is negative \$46.232 million, as compared
16 to the \$41.772 million amount on the comparable USWC workpaper for cash working
17 capital from the June 30, 1998 test year filing." The Company's response attributed the
18 change to the updated test year. The Company's response to Data Requests RUCO-28-7
19 and UTI-56-1, are shown on pages 4 and 5 of Attachment RCS-S1, and contain the
20 Company's admission that the cash working capital amount reflected in rate base in the
21 Corrected Exhibits of George Redding, filed on June 12, 2000 was in error, and state that
22 the correct amount should be the negative \$46.232 million as the rate base adjustment.
23

1 Q. HAVE YOU REVISED SCHEDULE E-24 TO REFLECT THE NEGATIVE \$46.232
2 MILLION CASH WORKING CAPITAL ALLOWANCE AMOUNT?

3 A. Yes. A revised Schedule E-24 is attached to my surrebuttal testimony.
4

5 Q. ARE YOU EXPRESSING AN OPINION REGARDING THE OTHER STAFF-
6 PROPOSED ADJUSTMENTS TO CASH WORKING CAPITAL, WHICH QWEST
7 WITNESS REDDING DISCUSSES AT PAGES 43-44 OF HIS REBUTTAL
8 TESTIMONY?

9 A. No, I am not.

10 ***Interest Synchronization***

11 Q. DOES THE COMPANY PRESENT ANY REBUTTAL TESTIMONY CONCERNING
12 INTEREST SYNCHRONIZATION?

13 A. Yes. Qwest witness Redding's rebuttal at page 48 merely notes that an interest
14 synchronization adjustment should be recalculated once adjustments affecting rate base
15 are finalized and accepted by the Commission. I agree with the concept of updating the
16 interest synchronization calculation to reflect the Commission's final determination of
17 rate base, weighted cost of debt, etc. With my surrebuttal testimony, I have included a
18 revised Schedule E-25 to reflect the revisions made to RUCO's calculated adjustment.
19

20 **IV. SUPPLEMENTAL DIRECT TESTIMONY**

21 Q. AT THE TIME OF THE FILING OF RUCO'S DIRECT TESTIMONY, A NUMBER
22 OF ISSUES WERE STILL UNDER INVESTIGATION, AND QWEST AND RUCO
23 HAD AGREED THAT RUCO WOULD BE ALLOWED TO PRESENT ADDITIONAL

1 TESTIMONY ON SUCH ISSUES WITH RUCO'S SURREBUTTAL. ARE YOU NOW
2 ADDRESSING SOME OF THOSE ISSUES IN YOUR SURREBUTTAL
3 TESTIMONY?

4 A. Yes. On behalf of RUCO, I am addressing in this surrebuttal testimony a few of the areas
5 for which analysis had not yet been completed as of the date of writing of RUCO's direct
6 testimony in this proceeding. Because of time limitations, not all of the issues identified
7 in my direct testimony have been analyzed and addressed for discussion and
8 quantification in RUCO's surrebuttal testimony. Consequently, silence on a particular
9 issue should not be construed as agreement with Qwest's proposed treatment. I have
10 attempted to focus on those areas with the largest dollar impact, where a reasonable
11 quantification of such impact could be made within the available time frame for
12 preparation of surrebuttal.

13 ***Reciprocal Compensation Revenue and Expense***

14 Q. WHAT IS RECIPROCAL COMPENSATION?

15 A. Reciprocal Compensation refers to the revenue received by Qwest from other carriers and
16 payments by Qwest to other carriers associated with traffic generated by customers of a
17 local carrier that relies upon the facilities of another carrier for completion of the call.

18
19 Q. WAS RECIPROCAL COMPENSATION ONE OF THE ISSUES FOR WHICH YOU
20 HAD NOT YET COMPLETED YOUR ANALYSIS FOR INCLUSION IN YOUR
21 DIRECT TESTIMONY?

22 A. Yes. In my direct testimony, concerning Reciprocal Compensation, I stated that:

23 A response to Data Request UTI 49-1S1 was received on August 1. A response to
24 UTI 64-15S1 was received August 2. We haven't had time to digest or follow

1 through on USWC's information. The treatment of reciprocal compensation is a
2 controversial area, where USWC is asking for a revenue increase of \$13.252
3 million, and an automatic adjustment clause. This is an important area, and
4 adequate time should be allowed in which to analyze the information.
5

6 Q. HAVE YOU CALCULATED AN ADJUSTMENT FOR RECIPROCAL
7 COMPENSATION?

8 A. Yes. On Schedule E-5, which is being filed with RUCO's surrebuttal testimony, I have
9 calculated an adjustment for Reciprocal Compensation. This adjustment removes the
10 Company's pro forma amounts of Reciprocal Compensation revenue and expense, and
11 reflects the actual test year amounts.
12

13 Q. HAVE YOU USED THE SAME APPROACH ADOPTED BY STAFF TO ADDRESS
14 RECIPROCAL COMPENSATION?

15 A. Yes, I have.
16

17 Q. DOES QWEST ADDRESS RECIPROCAL COMPENSATION IN ITS REBUTTAL
18 TESTIMONY?

19 A. Yes. At page 49 of his rebuttal testimony, Qwest witness Redding addresses Staff's
20 recommendations regarding Reciprocal Compensation. He acknowledges that the Staff
21 treatment allows the Company to at least recover the test year level of reciprocal
22 compensation, but criticizes Staff's recommendation because in his opinion it "makes no
23 provision for the future." (Redding rebuttal, page 49, lines 2-3.) The Company proposes
24 an automatic adjustment clause be implemented for Reciprocal Compensation.
25

1 Q. SHOULD AN AUTOMATIC ADJUSTMENT CLAUSE BE ADOPTED FOR
2 QWEST'S RECIPROCAL COMPENSATION?

3 A. No. An automatic adjustment clause or "rider" should not be adopted for Reciprocal
4 Compensation for the following reasons:

5 1) The Company's proposal represents improper, piecemeal ratemaking to single
6 out one element of the overall revenue requirement.

7 2) Reciprocal Compensation of approximately \$11 to \$13 million is
8 approximately one percent of Qwest's total Arizona intrastate operating revenues of
9 approximately \$1.2 billion. Moreover, the difference of approximately \$1.6 million in
10 revenue requirement (\$13.2 million per Qwest versus \$11.6 million per RUCO) resulting
11 from Qwest's attempt to use amounts beyond the end of the 1999 test year is only about
12 one tenth of one percent of Qwest's Arizona intrastate operating revenues. This is not
13 material enough to warrant a departure from traditional regulation.

14 3) Incentives for Qwest to prudently negotiate and administer reciprocal
15 compensation arrangements are diminished if the costs are automatically passed onto
16 ratepayers.

17 4) The introduction of quarterly or semi-annual filings, reviews and rate
18 adjustments for varying amounts of Reciprocal Compensation are not justified in view of
19 the relative impact of such cost variations to the accurate measurement of Qwest's
20 Arizona intrastate revenue requirement.

21 5) Under Arizona law, automatic adjustment clauses are reserved for those
22 expenses that are extremely volatile and which widely fluctuate. There is no evidence that
23 these criteria are applicable to the Reciprocal Compensation issue.

1
2 Q. DO YOU AGREE WITH STAFF WITNESS BROSCH'S CONCLUSION THAT,
3 UPON INCLUSION IN THE ARIZONA INTRASTATE REVENUE REQUIREMENT
4 CALCULATION OF QWEST'S ACTUAL 1999 AMOUNTS OF RECIPROCAL
5 COMPENSATION, THERE IS NO NEED FOR A SEPARATE LINE ITEM ADDING
6 \$13.3 MILLION TO THE CALCULATED REVENUE REQUIREMENT, AND THERE
7 IS NO NEED FOR FUTURE AUTOMATIC RATE ADJUSTMENT FOR CHANGES
8 IN THIS LEVEL OF COSTS?

9 A. Yes, I do. I also agree with Staff witness Brosch (direct testimony, page 89) that the test
10 period recorded values for Reciprocal Compensation represent the only known and
11 measurable amounts that are consistent with the other test period revenue and expense
12 levels.

13
14 Q. WHAT IMPACT DOES YOUR ADJUSTMENT FOR RECIPROCAL
15 COMPENSATION HAVE?

16 A. The calculation of this adjustment is shown on Schedule E-5, which is being filed with
17 my surrebuttal. In comparison with the "Per Company" amounts for Reciprocal
18 Compensation included in Column A of Schedule C in RUCO Exhibit ____ (L&A-1),
19 which was filed with my direct testimony, using the test year recorded amounts for
20 Reciprocal Compensation reduces revenues by \$1.371 million, and reduces operating
21 expenses before income taxes by \$2.943 million. After taking into account the income
22 tax expense impacts (shown on lines 24 and 25 of Schedule E-5), net operating income
23 increases by \$941,000.

Put another way, as shown in the following table, the Company's proposed \$13.252 million revenue requirement for Reciprocal Compensation is reduced by \$1.605 million, to \$11.648 million:

Description	Per Qwest	Per RUCO	Difference
Net Operating Income Impact	\$ (7,770)	\$ (6,829)	\$ 941
Gross Revenue Conversion Factor	1.7056	1.7056	1.7056
Intrastate Revenue Requirement Impact	\$ 13,253	\$ 11,648	\$ (1,605)

FCC Deregulated/ACC Regulated Products

Q. ARE YOU PROPOSING A RATEMAKING ADJUSTMENT RELATED TO THE FCC DEREGULATED/ACC REGULATED PRODUCTS?

A. Yes. As stated in my direct testimony, it appears that an adjustment similar to the one presented by Staff in the prior USWC rate case would also be warranted in the current USWC rate case. As of the date of the writing of my direct testimony, we had not determined an adjustment amount. After additional analysis of this issue, it appears that the adjustment calculated by Staff represents an appropriate resolution of this issue, and should be adopted in calculating Qwest's intrastate revenue requirement.

Q. HAS QWEST INDICATED THAT IT IS IN AGREEMENT WITH THE CALCULATION OF STAFF'S PROPOSED ADJUSTMENT FOR FCC DEREGULATED/ACC REGULATED PRODUCTS?

A. Yes. At pages 45-46 of his rebuttal, Qwest witness Redding indicates that he agrees with Staff witness Carver's "financial end result" which is based on the premise that the FCC deregulated products should not cross subsidize regulated products. Staff witness Carver

1 imputed revenues for the FCC deregulated/ACC regulated products to bring the return up
2 to the level being recommended in the overall intrastate revenue requirement.
3

4 Q. DOES QWEST DISAGREE WITH ANY ASPECT OF STAFF'S ADJUSTMENT?

5 A. At pages 45-46 of his rebuttal, Mr. Redding appears to disagree with the "methodology"
6 Staff used but not with the actual results of the calculation or its financial impact. At page
7 46, lines 14-16, of his rebuttal testimony, Mr. Redding states: "Qwest would have no
8 disagreement with removing these items from regulation, thus achieving symmetry with
9 their treatment in the interstate jurisdiction."
10

11 Q. IS IT NECESSARY TO TOTALLY REMOVE SUCH SERVICES FROM
12 REGULATION BY THE ACC IN ORDER TO PROTECT RATEPAYERS FROM
13 CROSS-SUBSIDIZATION?

14 A. Probably not. The Commission may want to keep such services as the provision of inside
15 wiring maintenance services under regulation for some purposes, such as consumer
16 protection, even though some other aspects of the service, such as pricing, are not subject
17 to Commission regulation. That is, a particular product could conceivably be deregulated
18 with respect to pricing, without it being totally removed from Commission regulation.
19

20 Q. HAVE YOU CALCULATED THE ADJUSTMENT FOR THE IMPUTATION OF
21 REVENUE FOR FCC DEREGULATED SERVICES?

1 A. Yes. This is shown on Schedule E-6, attached to my surrebuttal testimony. As noted in
2 my direct testimony, Schedule E-6 had been reserved for the purpose of calculating this
3 adjustment.

4
5 Q. IS THE AMOUNT OF THE ADJUSTMENT FOR THE IMPUTATION OF REVENUE
6 FOR FCC DEREGULATED SERVICES SLIGHTLY DIFFERENT FROM STAFF'S
7 CALCULATION WHEN RUCO'S RECOMMENDED RATE OF RETURN IS
8 APPLIED?

9 A. Yes. RUCO's recommended overall rate of return of 9.51% differs from Staff's
10 recommended rate of return of 9.68%. This difference results in a slight variance
11 between my recommended adjustment and the Staff's adjustment. Staff also made an
12 adjustment to the Uncollectibles portion of the Gross Revenue Conversion Factor
13 (GRCF), which also contributes to the variance.

14
15 Q. ARE YOU SAYING THAT YOU DISAGREE WITH STAFF'S ADJUSTMENT FOR
16 THE UNCOLLECTIBLES PORTION OF THE GRCF?

17 A. No. I am just pointing out that my imputation of revenue for FCC deregulated services on
18 Schedule E-6 does not include this impact.

19
20 Q. WHAT IS THE IMPACT OF YOUR ADJUSTMENT?

21 A. The adjustment reduces the intrastate revenue requirement by \$3.52 million.

22 **Broadband Cable TV**

23 Q. PLEASE DISCUSS THE BROADBAND CABLE TV ISSUE.

1 A. U S West Communications, Inc., now Qwest, is providing services to a recently created
2 affiliate, Broadband Services, Inc. ("BSI" or "Broadband"). In a concurrent docket,
3 Docket No. T-01051B-99-0499, the Company has requested approval of a Company-
4 proposed transfer of assets from USWC (now Qwest) to BSI and a Master Services
5 Agreement between USWC (now Qwest) and BSI. When Qwest provides services to
6 BSI, revenues and expense credits are recorded. Additionally, if the asset transfer from
7 Qwest to BSI were to be approved by the Commission, in whole or in part, the transferred
8 assets would need to be removed from rate base.

9 Issues are presented in the instant rate case concerning whether the revenues and
10 expense credits associated with the provision of services to Broadband have been
11 adequately reflected in the test year. The amount of rate base is also impacted by the
12 uncertain status of the Company-proposed asset transfer. The concurrent asset transfer
13 proceeding has been put on hold, while the telephone company, after being acquired by
14 Qwest, re-evaluates whether it wants to pursue the asset transfer. As stated in my direct
15 testimony (at page 21):

16 Based on preliminary indications, it appears that USWC has understated the
17 amounts of revenue it is receiving for services it is providing to BSI. USWC
18 receives lease revenue from BSI for BSI's use of USWC-owned assets. USWC
19 also provides a wide range of other services to BSI. For example, BSI contracts
20 with USWC for all customer service, installation and repair functions, as well as
21 for many other types of services described in the Master Services Agreement. As
22 a result, USWC records credits to operating expenses associated with the services
23 it provides to BSI. Based upon preliminary indications, it appears that USWC has
24 understated the amount of expense credits associated with services it provides to
25 the affiliate, BSI. The test year should be adjusted to reflect normalized levels of
26 revenues and expense credits associated with BSI's use of USWC-owned assets
27 and for the services USWC is providing to BSI.
28

1 Q. HAVE YOU REFLECTED AN ADJUSTMENT FOR BROADBAND CABLE TV
2 TRANSACTIONS?

3 A. Yes. On Schedule E-7, which is attached to my surrebuttal testimony, I have reflected the
4 adoption of Staff's proposed adjustments for Broadband revenues and expenses.
5

6 Q. DOES QWEST'S REBUTTAL ADDRESS SUCH STAFF ADJUSTMENTS?

7 A. Yes. At page 47 of his rebuttal testimony, concerning the Staff adjustment for revenues
8 and expenses related to Broadband, Qwest witness Redding states that: "Given the start-
9 up nature of BSI's operations, the Company does not believe that Mr. Brosch's
10 adjustments to the estimated billing between Qwest and BSI are unreasonable."
11 Concerning the asset amount, Mr. Redding states that, pending clarification of the
12 Company's intent with regard to the transfer of the assets, he has no disagreement with
13 Staff's proposed adjustment.
14

15 Q. DO YOU HAVE ANY CONCERNS THAT THE STAFF ADJUSTMENT, WITH
16 WHICH QWEST EXPRESSES NO DISAGREEMENT, MAY UNDERSTATE THE
17 REVENUES AND EXPENSE CREDITS THAT QWEST IS RECEIVING FROM
18 BROADBAND?

19 A. Yes. At page 21 of my direct testimony, I discussed the ongoing levels of revenues and
20 expense credits that the telephone company has been realizing during the first six months
21 of 2000. These are substantially higher than the amounts reflected in the 1999 test year,
22 even after reflecting Staff's adjustment.
23

1 Q. WHY HAVE YOU ADOPTED STAFF'S ADJUSTMENT FOR BROADBAND
2 CABLE TV-RELATED COSTS AND REVENUES?

3 A. After additional review and analysis, I have concluded that the Staff adjustment appears
4 to be a reasonable way of addressing the apparent understatement of test year revenues
5 and expense credits associated with the provision of services by the telephone company
6 (Qwest) to the affiliate, Broadband. While it appears that the ongoing level of revenues
7 and expense credits, as evidenced in the data for the first six months of 2000, which was
8 provided in response to Data Request UTI-51-8, is considerably larger than the amounts
9 reflected in the test year, even after reflecting Staff's adjustment, to capture such ongoing
10 levels would have required going outside of the 1999 test year. It is clear that the amounts
11 recorded in the test year by the Company did not reflect a full year of BSI operations.
12 Rather than attempt to update the revenues and expense credits associated with
13 Broadband by going outside the test year, with all of the attendant problems in doing so, I
14 have adopted Staff's approach of annualizing the test year recorded amounts as a
15 reasonable way of dealing with this issue in the context of the Company's 1999 test year
16 filing.

17
18 Q. HAVE YOU PRESENTED THE CALCULATION OF YOUR BROADBAND CABLE
19 TV ADJUSTMENT?

20 A. Yes. The calculation of this adjustment is shown on Schedule E-7, which is being filed
21 with RUCO's surrebuttal testimony. As mentioned in my direct testimony, Schedule E-7
22 had been reserved for this purpose. As described above, my Broadband adjustment adopts

1 the Staff adjustment calculations which were presented on Staff Schedules B-6 and C-6,
2 respectively.

3
4 Q. WHAT IS THE NET IMPACT OF YOUR BROADBAND ADJUSTMENT ON THE
5 INTRASTATE REVENUE REQUIREMENT?

6 A. The net impact of my Broadband adjustment is a reduction in the intrastate revenue
7 requirement of approximately \$362,000.

8 **V. UPDATED INTRASTATE REVENUE REQUIREMENT CALCULATIONS**

9 Q. AT THIS TIME, HAVE YOU UPDATED THE SUMMARY SCHEDULES
10 SUBMITTED ON BEHALF OF RUCO WITH YOUR DIRECT TESTIMONY TO
11 REFLECT A RE-CALCULATION OF THE COMPANY'S ARIZONA INTRASTATE
12 REVENUE REQUIREMENT?

13 A. Yes. As shown in RUCO Exhibit ____ (L&A-2), on Schedule A Revised, the Arizona
14 intrastate revenue excess for Qwest is \$34.1 million. Supporting details are included on
15 the other schedules previously filed with RUCO's direct testimony in Exhibit ____ (L&A-
16 1) and in the revised schedules filed with RUCO's surrebuttal in Exhibit ____ (L&A-2).

17
18 Q. WHAT SPECIFIC SCHEDULES ARE YOU PRESENTING WITH YOUR
19 SURREBUTTAL TESTIMONY?

- 1 A. The following table identifies the schedules contained in Exhibit __ (L&A-2), which is
2 being filed with RUCO's surrebuttal testimony:

Exhibit __ (L&A-2) of Larkin & Associates (Surrebuttal)

Schedule	Description	Pages	Witness	Redacted	Notes
A	Revenue Surplus or Deficiency	1	Smith	No	Revised
B	Rate Base	1	Smith	No	Revised
C	Adjusted Operating Income	1	Smith	No	Revised
D	Capital Structure and Cost of Capital	1	Smith	No	
E	RUCO Adjustments	7	Smith	Yes, Partially	Revised
E-5	Reciprocal Compensation	1	Smith	No	Calculated
E-6	FCC Nonregulated/ ACC Regulated Imputation/Loss Adjustment	1	Smith	No	Calculated
E-7	Broadband Revenues and Expenses	1	Smith	No	Calculated
E-24	Cash Working Capital - Adjust to US WEST Calculated Rate Base Amount	1	Smith	No	Revised
E-25	Interest Synchronization Adjustment	1	Smith	No	Revised
TOTAL PAGES		16			

- 3
4 Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?
5 A. Yes.

U S WEST
Arizona Intrastate Operations
C-05 Cash Working Capital
Test Year Ending December 31, 1999
(In Thousands of Dollars)

Date: 5/3/00
Time: 8:34 AM

	(a)	(b = a/365)	(c)	(d)	(e = b*d)
Fully Adjusted					
	Test Year	Avg Daily Amt	Source	Lag	CWC
1 Local Service Revenue	928,693	2544.4	Worksheet 1	19.4	49,361
2 Network Access Service Revenue	115,252	315.8	Worksheet 2	42.0	13,262
3 Long Distance Network Service Revenue	22,413	61.4	Worksheet 3	42.5	2,610
4 Billing and Collection Revenue	15,803	43.3	Worksheet 4	42.0	1,818
5 Miscellaneous Revenue	116,039	317.9	Worksheet 5	24.6	7,821
6 Total Operating Revenues(L1 .. L5)	1,198,200	3282.7	Composite Revenue	22.8	74,872
7 Maintenance Expense	282,322	773.5	Worksheet 6	22.5	(17,403)
8 Engineering Expense	11,500	31.5	Worksheet 7	25.9	(816)
9 Network Operations Expense	52,199	143.0	Worksheet 8	19.9	(2,846)
10 Network Administration Expense	2,337	6.4	Worksheet 9	20.6	(132)
11 Access Expense	23,571	64.6	Worksheet 10	43.8	(2,829)
12 Other Expense	1,301	3.6	Worksheet 11	55.1	(196)
13 Customer Operations Expense	219,291	600.8	Worksheet 12	26.3	(15,801)
14 Corporate Operations Expense	206,976	567.1	Worksheet 13	32.1	(18,203)
15 Property Taxes	49,804	136.4	Worksheet 14	206.6	(28,190)
16 Other Taxes (Excl Income Taxes)	(1,764)	-4.8	Worksheet 15	(25.4)	(123)
17 Uncollectibles	16,481	45.2	Worksheet 16	22.8	(1,030)
18 Depreciation	328,884	901.1		0.0	0
19 Current Federal Income Tax	37,249	102.1	Worksheet 17	36.0	(3,674)
20 Current State Income Tax	9,821	26.9	Worksheet 18	61.1	(1,644)
21 Deferred Taxes	(52,783)	-144.6		0.0	
22 Total Operating Expenses(L 7 .. L21)	1,187,189				(92,887)
23 Interest Expense	50,058	137.1	Worksheet 19	92.2	(12,645)
24 Federal Excise Taxes	20,796	57.0	Worksheet 20	0.2	(11)
25 Sales Tax	62,755	171.9	Worksheet 21	10.6	(1,822)
26 Average Benefit Liability			Worksheet 28		1,072
27 Total Miscellaneous(L23 ..L26)	133,609				(13,406)
28 Total Cash Working Capital Requirement (L6 +L22+L27)	2,385,430				(31,421)
Deduct Non Cash Items					
29 Depreciation	328,884	901.1	Composite Rev	22.8	(20,551)
30 Deferred Tax	(52,783)	-144.6	Composite Rev	22.8	3,298
31 Net Income (L6-L22-L23)	(39,047)	-107.0	Composite Rev	22.8	2,440
32 Total Non Cash Items(L29..L31)	237,054				(14,813)
33 Commission Basis Cash Working Capital (L28+L32)					

< 46,234 > ←

	Booked	Intrastate	Intrastate Percent
Local Service Revenue	954,933,510	954,933,510	
Network Access Revenue	603,899,634	121,079,275	
Toll Revenue	30,371,863	30,318,408	
	1,589,205,007	1,106,331,193	69.6154%

U S WEST
 Arizona Intrastate Operations
 C-05 Cash Working Capital
 Test Year Ending December 31, 1999
 (In Thousands of Dollars)

Date: 05/03/00
 Time: 8:34 AM

	(a) Fully Adjusted Test Year	(b=a/365) Avg Daily Amount	(c) Source	(d) Net Lag	(e=b*d) CWC
1 Maintenance Expense	282,322	773.5	Worksheet 6	0.3	238
2 Engineering Expense	11,500	31.5	Worksheet 7	(3.1)	(97)
3 Network Operations Expense	52,199	143.0	Worksheet 8	2.9	416
4 Network Administration Expense	2,337	6.4	Worksheet 9	2.2	14
5 Access Expense	23,571	64.6	Worksheet 10	(21.0)	(1,356)
6 Other Expense	1,301	3.6	Worksheet 11	(32.3)	(115)
7 Customer Operations Expense	219,291	600.8	Worksheet 12	(3.5)	(2,098)
8 Corporate Operations Expense	206,976	567.1	Worksheet 13	(9.3)	(5,269)
9 Property Taxes	49,804	136.4	Worksheet 14	(183.8)	(25,078)
10 Other Taxes (Excl Income Taxes)	(1,764)	-4.8	Worksheet 15	48.2	(233)
11 Uncollectibles	16,481	45.2	Worksheet 16	0.0	0
12 Current Federal Income Tax	37,249	102.1	Worksheet 17	(13.2)	(1,346)
13 Current State Income Tax	9,821	26.9	Worksheet 18	(38.3)	(1,030)
14 Total Operating Expenses(L 1 .. L13)	911,088				(35,954)
15 Federal Excise Taxes	20,796	57.0	Worksheet 20	0.2	(11)
16 Sales Tax	62,755	171.9	Worksheet 21	10.6	(1,822)
17 Interest Expense	50,058	137.1	Worksheet 19	(69.4)	(9,517)
18 Average Benefit Liability			Worksheet 28		1,072
19 Commission Basis Cash Working Capital					(46,232) ←
20 Revenue Lags not Recognized in the Netting Method					
21 Depreciation	328,884	901.1	Composite Rev	22.8	20,551
22 Deferred Taxes and ITC Amortized	(52,783)	-144.6	Composite Rev	22.8	(3,298)
23 Net Income	(39,047)	-107.0	Composite Rev	22.8	(2,440)
24 Total Non Cash Items(L21+L22+L23)					14,813
25 Total Cash Working Capital Requirement(L19+L24)					(31,419)

Arizona
Docket No. T-1051B-99-105
RUCO 28-006

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 006

Cash working capital. Refer to the response to UTI 42-1, Attachment A and to the Company's original workpapers for C-05, Cash Working Capital for the test year ending June 30, 1998.

a. Please confirm that USWC is not updating the negative \$41,772 million negative amount for Commission Basis Cash Working Capital shown on its workpapers for C-05, Cash Working Capital for the test year ending June 30, 1998. If this is not the case, please provide the updated Commission Basis Cash Working Capital amount, and all supporting workpapers and calculations.

b. Referring to the response to UTI 42-1, Attachment A, for C-05, Cash Working Capital for the test year ending December 31, 1999, explain why the Commission Basis Cash Working Capital amount on line 19 is negative \$46.232 million, as compared to the \$41.772 million amount on the comparable USWC workpaper for cash working capital from the June 30, 1998 test year filing. Identify exactly which items of the cash working capital calculation USWC has changed for its 1999 test year update filing, explain fully why each such item was changed, and provide the supporting workpapers and detail calculations showing how each new or revised amount in column a, "Fully Adjusted Test Year," and column d, "Net Lag," on Azty-1999.xls, WP2-AzCWCnc(CA) and column d, "Lag," on the preceding C-05 workpaper page, Azty-1999.xls, WP1-AzCWCnc(CA), were derived.

RESPONSE:

a. The Company does confirm that the \$41,772M filed for the test year ending June 30, 1998 is not being updated. The updated test year is December 31, 1999.

b. Anytime a test year changes the CWC will change because all line items on the income statement column will change. All back up was provided in UTI 42-001.

Fran Bendever
Finance Analyst
1801 California St. Room 1240
Denver, CO 80202

Arizona
Docket No. T-1051B-99-105
UTI 56-001

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 001

Re: Corrected Exhibits of George Redding, filed June 12, 2000 USWC's adjusted pro-forma Allowance for Cash Working Capital in rate base (GAR-S4) is \$(39,211). However, the C-05 adjustment workpapers reflect "Commission Basis Cash Working Capital of \$(46,232). Please explain and reconcile this apparent discrepancy and provide additional calculation workpapers supportive of the Company's position, if other than \$(46,232).

RESPONSE:

The explanation is, an error occurred in the Company's adjustment. The correct amount should be \$(46,232) as a rate base adjustment.

Fran Bendever
Finance Analyst
1801 California St.
Denver, CO 80202

Arizona
Docket No. T-1051B-99-105
RUCO 28-007

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 007

Cash working capital. Refer to the response to UTI 42-1, Attachment A. Does USWC have any explanation for why it failed to reflect the Commission Basis Cash Working Capital amount on line 19 of on (sic) Azty-1999.xls, WP2-AzCWCnc(CA) of negative \$46.232 million as the Rate Base adjustment amount on Adjustment C-05 for its updated 1999 test year? If so, provide a complete statement of such explanation, along with specific citations to any and all Commission orders and other authority being relied upon by USWC for reflect an amount other than the Commission Basis Cash Working Capital in rate base.

RESPONSE:

The explanation is that the \$14.8 M amount shown in the Company's adjustment is incorrect. The correct amount should be \$46.232 Million as a rate base adjustment.

Fran Bendeever
Finance Analyst
1801 California St. Room 1240
Denver, CO 80202

**BEFORE THE
ARIZONA CORPORATION COMMISSION**

U. S. WEST COMMUNICATIONS, INC.

Docket No. T-1051B-99-105

SURREBUTTAL TESTIMONY

OF

**LARKIN & ASSOCIATES
HUGH LARKIN, JR.**

ON BEHALF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

**Phoenix, Arizona
September 2000**

**TESTIMONY OF HUGH LARKIN, JR.
TABLE OF CONTENTS**

	<u>Page</u>
I. INTRODUCTION	1
II. DIRECTORY REVENUE IMPUTATION	1
III. INCENTIVE COMPENSATION	3
IV. NON-PRODUCT ADS, OLYMPIC & SPORTS SPONSORSHIP	9

1

2 I. INTRODUCTION**3 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

4 A. Hugh Larkin, Jr.. My business address is: Larkin & Associates, 15728 Farmington Road,
5 Livonia, Michigan 48154.

6

7 Q. ARE YOU THE SAME HUGH LARKIN, JR. WHO PREVIOUSLY SUBMITTED
8 TESTIMONY IN THIS CASE?

9 A. Yes, I am.

10

11 Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

12 A. The purpose of my surrebuttal testimony on behalf of the Arizona Residential Utility
13 Consumer Office (RUCO) is to respond to certain issues presented in the rebuttal
14 testimony of Qwest Corporation, the regulated telecommunications subsidiary of Qwest
15 Communications International, Inc. Qwest Corporation is the new name of the former U
16 S West Communications, Inc. Consequently, in my surrebuttal testimony, I will refer to
17 the former U S West Communications, Inc. as Qwest or the Company. In my surrebuttal
18 testimony, I am addressing two areas in my initial testimony that were rebutted by Qwest,
19 specifically incentive compensation and directory revenues.

20 II. DIRECTORY REVENUE IMPUTATION

21 Q. PLEASE DISCUSS ANN KOEHLER-CHRISTENSEN'S REBUTTAL TESTIMONY
22 ON THE SUBJECT OF DIRECTORY REVENUE.

23 A. In her rebuttal testimony, Ms. Koehler-Christensen attempts to rebut RUCO and Staff's
24 position that the directory revenue imputation adjustment, which has been a regular

1 recurring adjustment for over ten years, should be discontinued. The imputation was part
2 of the settlement agreement entered into by the parties in 1988 and has recently been
3 upheld by the Court of Appeals. Ms. Koehler-Christensen's rebuttal testimony is not
4 persuasive and provides no compelling argument for reversing this long-standing and
5 long accepted adjustment.

6
7 Q. PLEASE DISCUSS MS. KOEHLER-CHRISTENSEN'S REBUTTAL TESTIMONY IN
8 REGARDS TO STAFF WITNESS BROSCH'S ASSERTION THAT THE COMPANY
9 SHOULD HAVE OBTAINED COMPETITIVE BIDS FOR THE PUBLICATION OF
10 WHITE PAGES.

11 A. Staff Witness Brosch claims in his direct testimony that the Company should have
12 obtained competitive bids for the publication of the white pages. In rebuttal to his
13 testimony, Ms. Koehler-Christensen asserts that Mr. Brosch has provided no evidence of
14 what the results of such bids might have been and that none of the RBOCs have ever
15 solicited bids. She indicates that "DEX has been publishing directories as a separate
16 affiliate for the last sixteen years and has never been asked to bid for the right to be the
17 official publisher of a CLEC or ILEC." Her arguments ignore the fact that DEX is an
18 affiliated company to Qwest. As such, there should be a higher level of scrutiny in
19 regards to transactions between DEX and Qwest. Without Qwest undergoing a
20 competitive bid process, there is no way to know whether or not the transactions between
21 itself and its affiliate are reasonable or what the actual value of those services may be.
22 Mr. Brosch had "no evidence of what the results of such a bid may have been" because
23 the Company has not instigated a competitive bid process.

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Q. IS IT STILL YOUR POSITION THAT THE DIRECTORY REVENUE IMPUTATION
ADJUSTMENT, WHICH INCREASES REVENUES BY \$41.3 MILLION, SHOULD
BE ADOPTED BY THE COMMISSION?

A. Yes, it is.

III. INCENTIVE COMPENSATION

Q. PLEASE DISCUSS THE COMPANY'S OVERALL REBUTTAL TO YOUR
ADJUSTMENT TO INCENTIVE COMPENSATION EXPENSE.

A. Qwest's overall stance in this case appears to be that if it incurs a cost, that cost should
not be questioned and should automatically be flowed through to ratepayers. Under the
Company's overall annualization approach (i.e., December 1999 amounts times 12), it
would not allow for the scrutiny of individual expense items. It appears that Qwest
believes its overall cost levels are appropriate and that scrutiny of individual cost items is
unwarranted.

Q. DO YOU AGREE WITH QWEST'S POSITION?

A. No. One of the purposes of regulatory oversight is to ensure that captive ratepayers are
not held responsible for costs which should not be allocated to them. The Company's
approach would essentially discontinue any sort of prudency reviews or analysis of
specific cost items.

1 At page 6 of his Rebuttal Testimony, Mr. Grate contends that "Under cost of service
2 regulation, ratepayers are protected from whatever market power utilities possess by the
3 setting of rates based on cost and no more; Utilities are protected from confiscation by
4 the setting of rates based on cost and no less." His rebuttal ignores one of the purposes of
5 regulation, which is to ensure that the captive ratepayers are not being harmed through
6 the market power of the utilities. There remains a need to scrutinize the costs the
7 monopoly utility incurs, not to merely accept them at face value with no analysis or
8 review.

9
10 Q. DID QWEST AGREE WITH ANY PART OF YOUR ADJUSTMENT FOR
11 INCENTIVE COMPENSATION EXPENSE?

12 A. Yes and no, depending on if you rely on Qwest's rebuttal testimony, or its response to
13 subsequent data requests. In my direct testimony, I recommended that 50% of the costs
14 associated with the Short Term Incentive Plan (STIP), Annual Bonus Plan (ABP) and IT-
15 Career Structure Bonus Plan be removed and 100% of the Long Term Incentive Plan
16 (LTIP) be removed. In his Rebuttal Testimony, at page 5, Mr. Grate indicates that he
17 does not oppose adjusting LTIP expenses out of the test year. As stated in his rebuttal
18 testimony, "The LTIP has been replaced with a plan that relies exclusively on stock
19 options, which generate no operating expenses." He continues, stating "the Company
20 expects to bear no expenses for LTIP after 2000." Mr. Grate then acknowledges on lines
21 11-12 of page 5 of his rebuttal testimony that he does not oppose the removal of the LTIP
22 expense. However, in response to UTI 71-008 (which was responded to by Mr. Grate),
23 the Company responded as follows:

1 Mr. Grate did not recommend adjusting the test year to eliminate LTIP expenses
2 because the test year incentive compensation expenses, in total and with LTIP
3 expenses being absent, are below the level the Company believes will be ongoing.
4 See Mr. Redding's testimony regarding year end annualization to better reflect
5 ongoing levels of expense.
6

7 Apparently, the Company agrees that the LTIP cost will not be incurred in the rate year
8 and does not oppose the removal in its Rebuttal Testimony, then it directly opposes the
9 removal in a subsequent data response. This once again demonstrates that the
10 Company's proposed methodology is to ignore the prudence and/or appropriateness of
11 specific expense items, and recommends that the Commission just rubber stamp all costs
12 incurred by the Company regardless of the appropriateness. Clearly, the inclusion of
13 non-recurring costs in the adjusted test year is not appropriate.
14

15 Q. DO ANY ADDITIONAL RECOMMENDATIONS IN MR. GRATE'S REBUTTAL
16 TESTIMONY CONFLICT WITH THE COMPANY'S OVERALL APPROACH
17 REGARDING APPROVING OVERALL EXPENSE LEVELS AND NOT SPECIFIC
18 EXPENSE ITEMS?

19 A. Yes. At pages 29 – 30 of his rebuttal testimony, Mr. Grate addresses my assertion that
20 some of the specific business unit goals are in direct conflict with ratepayer concerns,
21 along with my recommendation that 50% of the ABP costs be disallowed. As mentioned
22 above, the Company would prefer that overall cost levels be approved and that specific
23 components of the costs be essentially ignored. For example, the Company has agreed
24 that the LTIP costs will not be incurred after the year 2000, yet asserts that the overall
25 cost level that includes the LTIP is "reasonable" and should be adopted, inclusive of the
26 non-recurring LTIP costs. However, at page 29 of his rebuttal testimony, when

1 addressing my concerns regarding the APB goals, Mr. Grate states that "I believe that the
2 remedy for work that directly conflicts with ratepayer concerns is to determine whether
3 the work is unnecessary or imprudent, and if it is, to disallow all the costs of it." In one
4 regard, the Company indicates that overall cost levels should be evaluated and not
5 individual costs, in the other regard the Company indicates that the hundreds of
6 individual goals included in the ABP should be analyzed and quantified in making a
7 recommendation for disallowance. Apparently, the Company wants the best of both
8 worlds, depending upon which would better serve its interests.

9
10 Q. MR. GRATE'S TESTIMONY INCLUDES A HYPOTEHTICAL CALCULATION
11 WHICH PURPORTEDLY DEMONSTRATES THAT RATEPAYERS ARE BETTER
12 OFF IN SITUATIONS IN WHICH A UTILITY HAS AN INCENTIVE
13 COMPENSATION PLAN. DOES THE HYPOTHETICAL INCLUDED IN HIS
14 TESTIMONY PERTAIN SPECIFICALLY TO QWEST AND ITS SITUATION?

15 A. No, it does not. The hypothetical presented by Mr. Grate is very simplistic and based on
16 the assumptions he presents. When asked specific questions regarding the hypothetical
17 calculations presented in his testimony and the intent of the hypothetical in UTI 71-015
18 and UTI 71-016, Mr. Grate replied: "the purpose of the mathematical demonstration is
19 pedagogical." The hypothetical is overly simplistic, is not specific to U S
20 West's/Qwest's experience and should be given no weight.

21
22 Q. DID MR. GRATE'S REBUTTAL TESTIMONY CAUSE YOU TO REVISE YOUR
23 POSITION REGARDING THE INCENTIVE COMPENSATION COSTS?

1 A. No, it did not. I continue to recommend that 50% of the costs associated with the STIP,
2 ABP and Information Technologies Career Structure Bonus Plan be removed, along with
3 100% of the LTIP costs. The Company has not disputed the fact that shareholders also
4 benefit from these plans and that several of the goals of these plans are driven by factors
5 that serve to benefit shareholders, sometimes at ratepayer expense.

6
7 Q. AT PAGES 16 – 17 OF HIS REBUTTAL TESTIMONY, MR. GRATE STATES THAT
8 YOUR RATIONALE FOR DISALLOWING 50% OF THE INCENTIVE PLAN COSTS
9 IS NOT SOUND RATEMAKING POLICY. PLEASE COMMENT ON HIS
10 REBUTTAL.

11 A. Mr. Grate indicates that my argument for allocating 50% of the costs to shareholders
12 based on the fact that shareholders benefit from the targets in the incentive plans would
13 discourage utilities from incurring costs to improve business efficiency and financial
14 performance. He indicates that if my “rationale were consistently applied in ratemaking,
15 then 50% of any cost aimed at fostering or improving business efficiency would be
16 disallowed...” Mr. Grate misses the point. The implementation of the incentive
17 compensation plan is at the discretion of the Company and its shareholders. It is the
18 Company’s management who has complete control over what targets and goals are set
19 within the various incentive compensation plans. As discussed in my direct testimony,
20 the Company has chosen to set the targets and goals based on factors that serve to benefit
21 the Company’s shareholders. Setting the annual goals and targets are within the complete
22 control of the Company, with ratepayers having no input into the process. If such targets
23 and goals serve to promote goals that are primarily within shareholders interest, they

1 should share in bearing the cost of the associated plans. In fact, as pointed out in my
2 direct testimony, several of the specific business unit goals under the ABP are in direct
3 conflict with ratepayer concerns. Clearly ratepayers should not be responsible for 100%
4 of these costs.

5
6 Q. DID QWEST REBUT YOUR RECOMMENDATION THAT 50% OF THE COSTS
7 ASSOCIATED WITH THE INFORMATION TECHNOLOGY CAREER STRUCTURE
8 BONUS PLAN BE REMOVED?

9 A. Yes. As pointed out in my direct testimony, the structure of the Information Technology
10 (IT) unit has changed, with the employees having been transferred to an affiliated
11 company, Qwest Information Technologies, Inc. RUCO specifically asked the Company
12 if the IT bonus would continue at the level included in the 1999 test year and the
13 Company did not directly answer the question posed. In his rebuttal testimony, Mr. Grate
14 indicates that the costs of the employees who received bonuses under the IT Career
15 Structure Bonus Plan (ITCSBP) have become employees of Qwest Information
16 Technologies, Inc. and the costs are now recorded on that company's books. He also
17 indicates that Qwest bears the costs of the plan to the extent the costs of Qwest IT
18 employees are affiliate-billed to Qwest. However, the Company has presented no factual
19 evidence, nor even a discussion, regarding the level of costs that will now be allocated to
20 Qwest for these employees and how that cost level compares to the costs included in the
21 adjusted test year which still reflects those employees as employees of Qwest. Mr. Grate
22 states that "The cost of the plan should follow and be allowed to the same extent as all
23 other employee compensation costs included in charges affiliate billed to Qwest."

1 Despite this assertion, Qwest has provided absolutely no information regarding the level
2 of the ITCSBP costs that will now be allocated to Qwest from Qwest IT and how that
3 amount compares to the amounts actually incurred by Qwest prior to the employee
4 transfers. Accordingly, there is no evidence to support Mr. Grate's contention that future
5 cost allocations of the IT costs will be commensurate with the level incurred during 1999
6 prior to the transfer of these employees to an affiliate.
7

8 **IV. NON-PRODUCT ADS, OLYMPIC & SPORTS SPONSORSHIP**

9 Q. THE REBUTTAL TESTIMONY OF QWEST WITNESS REDDING, AT PAGES 35-
10 40, ARGUES THAT CUSTOMERS SHOULD BEAR THE COST OF NON-PRODUCT
11 ADVERTISING. PLEASE RESPOND.

12 A. Non-product advertising, unlike product advertising, is of little or no benefit to the
13 Arizona jurisdictional ratepayers. The purpose of non-product advertising is to promote
14 the image of US WEST, now Qwest, and not to attempt to sell specific products to
15 ratepayers, which would increase regulated revenue in Arizona. While the Company may
16 argue that it is appropriate to promote the corporate or Company image, the link between
17 non-product advertising and increased sales of regulated services in Arizona is remote
18 and certainly not quantifiable. Therefore, it is appropriate to remove from the test year
19 revenue requirement any non-product/image advertising expenses.
20

21 Q. AT PAGE 39 OF HIS REBUTTAL, MR. REDDING STATES THAT EVERY LARGE
22 COMPANY, REGARDLESS OF INDUSTRY, ENGAGES IN IMAGE ADVERTISING

1 AND INCLUDES IN ITS PRICE AN ELEMENT OF THAT COST. DO YOU AGREE
2 WITH THIS?

3 A. No. While large companies in many industries engage in image advertising, in
4 competitive industries the price for service is based on market conditions, whereas for
5 regulated telephone services, the price for non-competitive services is based on the
6 recovery of costs associated with those products. Basic telephone service is considered
7 an essential in today's economy. Image advertising by Qwest does nothing to change
8 this. Consequently, the cost of such image advertising should not be included in the price
9 of regulated, non-competitive services.
10

11 Q. HAS QWEST DEMONSTRATED THAT THERE IS A STRONG LINKAGE
12 BETWEEN INCREASED SALES OF REGULATED TELEPHONE SERVICES TO
13 ARIZONA CUSTOMERS AND IMAGE ADVERTISING?

14 A. No. The quotes from author Tom Peters on pages 36-37 of Mr. Redding's rebuttal
15 testimony certainly do not demonstrate this.
16

17 Q. WOULD IT BE PUNITIVE TO DISALLOW THE COMPANY'S NON-PRODUCT
18 ADVERTISING EXPENSE FOR ARIZONA INTRASTATE RATEMAKING
19 PURPOSES?

20 A. No, it would not. Disallowance of such expense for ratemaking purposes would merely
21 protect ratepayers of regulated, non-competitive services from paying a cost that provides
22 them with no direct benefit. If Qwest management determines that there is benefit to the
23 Company from non-product advertising, and that such benefits outweigh the cost being

1 borne by shareholders, of course, the Company is free to engage in such image
2 advertising efforts.
3

4 Q. HAVE CORPORATE IMAGE-BUILDING ADVERTISING COSTS
5 TRADITIONALLY BEEN DISALLOWED FOR RATEMAKING PURPOSES?

6 A. Yes, they have.
7

8 Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?

9 A. Yes, it does.

U S WEST COMMUNICATIONS, INC.

Docket No. T-1051B-99-105

Exhibit ____ (L&A-2) of Larkin & Associates (Surrebuttal) On Behalf of RUCO Contents

Schedule	Description	Pages	Witness	Redacted	Notes
A	Revenue Surplus or Deficiency	1	Smith	No	Revised
A-1	Gross Revenue Conversion Factor	1	Smith	No	Note A
B	Rate Base	1	Smith	No	Revised
C	Adjusted Operating Income	1	Smith	No	Revised
D	Capital Structure and Cost of Capital	1	Smith	No	
E	RUCO Adjustments	7	Smith	Yes, Partially	Revised
E-1	Reverse Inappropriate Portions of US WEST Annualization Adjustment	1	Smith	No	Note A
E-2	Revenue Annualization	4	Larkin	Yes	Note A
E-3	Directory Revenue Imputation	1	Larkin	Yes	Note A
E-4	Universal Service Revenue	1	Smith	No	Note A
E-5	Reciprocal Compensation	1	Smith	No	Calculated
E-6	FCC Nonregulated/ ACC Regulated Imputation/Loss Adjustment	1	Smith	No	Calculated
E-7	Broadband Revenues and Expenses	1	Smith	No	Calculated
E-8	Adjustment to Intrastate Depreciation Expense	1	Smith	No	Note A
E-9	Investment Tax Credit Amortization	1	Smith	Yes	Note A
E-10	Remove Pension Asset from Rate Base	1	Smith	No	Note A
E-11	Wages and Salaries - Test Year	4	Larkin	Yes	Note A
E-12	Incentive Compensation	1	Larkin	Yes	Note A
E-13	Management Wages and Salaries - Post Test Year	1	Larkin	Yes	Note A
E-14	Occupational Wages and Salaries - Post Test Year	1	Larkin	Yes	Note A
E-15	Software Capitalization - SOP 98-1	1	Smith	Yes	Note A
E-16	Split Public Policy Organization Costs Between Ratepayers and Shareholders	1	Smith	No	Note A
E-17	Remove Non-Product Advertising Expense	1	Larkin	Yes	Note A
E-18	Normalize Product Advertising Expense	1	Larkin	Yes	Note A
E-19	Remove Sports Team Sponsorships Expense	1	Larkin	Yes	Note A
E-20	Remove Olympic Sponsorship Expense	1	Larkin	Yes	Note A
E-21	Remove Out-Of-Period Income Tax Expense	1	Smith	No	Note A
E-22	Reflect Sharing of Gain on Sale of 38 Arizona Exchanges with Traffic	1	Smith	Yes	Note A
E-23	Service Quality Plan	1	Smith	Yes	Note A
E-24	Cash Working Capital - Adjust to US WEST Calculated Rate Base Amount	1	Smith	No	Revised
E-25	Interest Synchronization Adjustment	1	Smith	No	Revised
TOTAL PAGES		43	Note A		
PAGES IN EXHIBIT FILED WITH SURREBUTTAL		16			

Note A: No Change from Exhibit __ (L&A-1) filed with RUCO's direct testimony. Only the revised or calculated schedules, as indicated above, are being filed in Exhibit __ (L&A-2) with RUCO's surrebuttal.

U S WEST COMMUNICATIONS, INC
ARIZONA INTRASTATE OPERATIONS
TEST YEAR ENDING December 31, 1999
(IN THOUSANDS OF DOLLARS)

Docket No. T-1051B-99-105
Schedule A Revised
Page 1 of 1

Revenue Surplus or Deficiency

Line No.	Description	Reference For Col.A	Per RUCO (A)	Per Company (B)	Difference (C)
I. Original Cost					
1	Adjusted rate base	Sch.B Revised	\$ 1,404,500	\$ 1,422,099	\$ (17,599)
2	Required rate of return	Schedule D	9.51%	10.86%	-1.35%
3	Required operating income		\$ 133,568	\$ 154,440	\$ (20,872)
4	Adjusted net operating income	Sch.C Revised	\$ 153,561	\$ 43,832	\$ 109,729
5	Operating income deficiency (sufficiency)		\$ (19,993)	\$ 110,608	\$ (130,601)
6	Gross revenue conversion factor	Schedule A-1	1.7056	1.7056	
7	Change in revenue requirement		\$ (34,101)	\$ 188,653	\$ (222,754)
8	Three year revenue requirement			\$ (686)	\$ 686
9	Reciprocal comp. automatic adj. mechanism		\$ -	\$ 13,252	\$ (13,252)
10	Total change in revenue requirement		<u>\$ (34,101)</u>	<u>\$ 201,219</u>	<u>\$ (235,320)</u>
II. Fair Value					
11	Adjusted rate base	Note A	\$ 1,742,100	\$ 1,763,930	\$ (21,830)
12	Required rate of return	Note B	7.67%	10.86%	-3.19%
13	Required operating income		\$ 133,568	\$ 191,563	\$ (57,995)
14	Adjusted net operating income	Sch.C Revised	\$ 153,561	\$ 43,832	\$ 109,729
15	Operating income deficiency (sufficiency)		\$ (19,993)	\$ 147,731	\$ (167,724)
16	Gross revenue conversion factor	Schedule A-1	1.7056	1.7056	
17	Change in revenue requirement		\$ (34,101)	\$ 251,970	\$ (286,071)
18	Three year revenue requirement			\$ (686)	\$ 686
19	Reciprocal comp. automatic adj. mechanism		\$ -	\$ 13,252	\$ (13,252)
20	Total change in revenue requirement		<u>\$ (34,101)</u>	<u>\$ 264,536</u>	<u>\$ (298,637)</u>

Notes

- A Same proportion as Company Fair Value rate base to Original Cost rate base
B Required return adjusted to produce same required operating income as Original Cost

USWC amounts in Column B, lines 1-10, are from Redding Supplemental (5/3/2000), Exhibit GAR-1
USWC did not present a Fair Value with that filing
USWC's amounts for Column B, lines 11-20, are from the response to UTI 43-20 S1

U S WEST COMMUNICATIONS, INC
ARIZONA INTRASTATE OPERATIONS
TEST YEAR ENDING December 31, 1999
(IN THOUSANDS OF DOLLARS)

Docket No. T-1051B-99-105
Schedule B Revised
Page 1 of 1

Adjusted Original Cost Rate Base

Line No.	Description	Per Company (A)	RUCO Adjustments (B)	Per RUCO (C)
1	Telephone Plant In Service	\$ 3,566,015	\$ 47,635	\$ 3,613,650
2	Short-Term Plant Under Construction	\$ -	\$ -	\$ -
3	Materials and Supplies	\$ 18,386	\$ -	\$ 18,386
4	Allowance for Cash Working Capital	\$ (39,211)	\$ (7,021)	\$ (46,232)
5	Accumulated Depreciation & Amortization Reserve	\$ (1,923,025)	\$ (3,400)	\$ (1,926,425)
6	Accumulated Deferred Income Tax	\$ (240,535)	\$ 12,093	\$ (228,442)
7	Customer Deposits	\$ (7,711)	\$ -	\$ (7,711)
8	Land Development Agreement Deposits	\$ (18,040)	\$ -	\$ (18,040)
9	Other Assets & Liabilities	\$ 65,535	\$ (66,221)	\$ (686)
10	End-of-Period Rate Base	<u>\$ 1,421,414</u>	<u>\$ (16,914)</u>	<u>\$ 1,404,500</u>

Notes

Column A is from USWC witness Redding's May 3, 2000 Supplemental, Exhibit GAR-S4

Details for Column B (RUCO Adjustments) are shown on Schedule E

U S WEST COMMUNICATIONS, INC
ARIZONA INTRASTATE OPERATIONS
TEST YEAR ENDING December 31, 1999
(IN THOUSANDS OF DOLLARS)

Docket No. T-1051B-99-105
Schedule C Revised
Page 1 of 1

Adjusted Net Operating Income

Line No.	Description	Per Company (A)	RUCO Adjustments (B)	Per RUCO (C)
Revenues				
1	Local Service Revenues	\$ 928,694	\$ 12,390	\$ 941,084
2	Network Access Service Revenues	\$ 115,252	\$ (1,983)	\$ 113,269
3	Long Distance Network Service Rev.	\$ 22,413	\$ 3,306	\$ 25,719
4	Miscellaneous	\$ 131,842	\$ 53,858	\$ 185,700
5	Total Oper. Rev. (L1 thru L4)	<u>\$ 1,198,201</u>	<u>\$ 67,571</u>	<u>\$ 1,265,772</u>
Expenses				
6	Maintenance	\$ 262,322	\$ (39)	\$ 262,283
7	Engineering Expense	\$ 10,745	\$ (1,025)	\$ 9,720
8	Network Operations	\$ 49,225	\$ (5,036)	\$ 44,189
9	Network Administration	\$ 2,212	\$ (286)	\$ 1,926
10	Access Expense	\$ 21,945	\$ 14,859	\$ 36,804
11	Other	\$ 1,271	\$ (294)	\$ 977
12	Total Cost of Svcs & Products(L6 thru L11)	<u>\$ 347,720</u>	<u>\$ 8,179</u>	<u>\$ 355,899</u>
13	Customer Operations	\$ 219,291	\$ (27,683)	\$ 191,608
14	Corporate Operations	\$ 206,975	\$ (33,886)	\$ 173,089
15	Property & Other Taxes	\$ 48,041	\$ (6)	\$ 48,035
16	Uncollectibles	\$ 16,480	\$ (100)	\$ 16,380
17	Tot Selling, Gen. & Admin.(L13 thru L16)	<u>\$ 490,787</u>	<u>\$ (61,675)</u>	<u>\$ 429,112</u>
18	Other Operating Income & Expense	\$ 174	\$ (22,853)	\$ (22,679)
19	Depreciation Expense	\$ 328,884	\$ (49,744)	\$ 279,140
20	Universal Service Fund	\$ -	\$ -	\$ -
21	Link Up America	\$ (117)	\$ 29	\$ (88)
22	Total Operating Expense(L12+L17 thru L21)	<u>\$ 1,167,448</u>	<u>\$ (126,064)</u>	<u>\$ 1,041,384</u>
23	Income From Operations (L5-L22)	<u>\$ 30,753</u>	<u>\$ 193,635</u>	<u>\$ 224,388</u>
Taxes				
24	Federal Income Tax	\$ (7,078)	\$ 60,199	\$ 53,121
25	State & Local Income Tax	\$ 1,365	\$ 16,341	\$ 17,706
26	Net Operating Income (L23-L24-L25)	<u><u>\$ 36,466</u></u>	<u><u>\$ 117,095</u></u>	<u><u>\$ 153,561</u></u>

ok

Notes

Column A amounts include US WEST's "SC" (three-year revenue requirement adjustments) and the adjustments from US WEST's supplemental testimony of George Redding, as corrected in response to UTI-56-2, Attachment A.

Details for Column B (RUCO Adjustments) are shown on Schedule E

RUCO Adjustments Summary

(Amounts in Thousands)		Reverse Inappropriate Portions of US WEST			
RUCO Adjustments Summary		RUCO Adjustment Summary Total	Annualization Adjustment	Revenue Annualization	Directory Revenue Imputation
Line No.	Description		E-1	E-2	E-3
Revenues					
1	Local Service Revenues	\$ 12,390	\$ (12,444)		
2	Network Access Service Revenues	\$ (1,983)	\$ (1,983)		
3	Long Distance Network Service Rev.	\$ 3,306	\$ 3,306		
4	Miscellaneous	\$ 53,858	\$ 5,100		
5	Total Oper. Rev. (L1 thru L4)	\$ 67,571	\$ (6,021)		
Expenses					
6	Maintenance	\$ (39)	\$ 9,259		
7	Engineering Expense	\$ (1,025)	\$ (453)		
8	Network Operations	\$ (5,036)	\$ (1,996)		
9	Network Administration	\$ (286)	\$ (192)		
10	Access Expense	\$ 14,859	\$ 17,752		
11	Other	\$ (294)	\$ (248)		
12	Total Cost of Svcs & Products(L6 thru L11)	\$ 8,179	\$ 24,122		
13	Customer Operations	\$ (27,683)	\$ (18,600)		
14	Corporate Operations	\$ (33,886)	\$ (14,802)		
15	Property & Other Taxes	\$ (6)	\$ (7)		
16	Uncollectibles	\$ (100)	\$ (111)		
17	Tot Selling, Gen. & Admin.(L13 thru L16)	\$ (61,675)	\$ (33,520)		
18	Other Operating Income & Expense	\$ (22,853)	\$ (366)		
19	Depreciation Expense	\$ (49,744)	\$ -		
20	Universal Service Fund	\$ -	\$ (1,370)		
21	Link Up America	\$ 29	\$ 29		
22	Total Operating Expense(L12+L17 thru L21)	\$ (126,064)	\$ (11,105)		
23	Income From Operations (L5-L22)	\$ 193,635	\$ 5,084		
Taxes					
24	Federal Income Tax	\$ 60,199	\$ 1,637		
25	State & Local Income Tax	\$ 16,341	\$ 407		
26	Net Operating Income (L23-L24-L25)	\$ 117,095	\$ 3,040		
Other					
27	Nonoperating Income & Expense	\$ -	\$ -		
28	Nonoperating Income Tax	\$ -	\$ -		
29	Net Operating Earnings (L26-L27-L28)	\$ 117,095	\$ 3,040		
30	Interest Expense	\$ -	\$ -		
31	Juris Diff & Nonreg Net Income	\$ -	\$ -		
32	Extraordinary Items	\$ -	\$ -		
33	Net Income (L29-L30-L31-L32)	\$ 117,095	\$ 3,040		
Rate Base					
34	Telephone Plant In Service	\$ 47,635	\$ -		
35	Short-Term Plant Under Construction	\$ -	\$ -		
36	Materials and Supplies	\$ -	\$ -		
37	Allowance for Cash Working Capital	\$ (7,021)	\$ -		
38	Accumulated Depreciation & Amortization Resen	\$ (3,400)	\$ -		
39	Accumulated Deferred Income Tax	\$ 12,093	\$ -		
40	Customer Deposits	\$ -	\$ -		
41	Land Development Agreement Deposits	\$ -	\$ -		
42	Other Assets & Liabilities	\$ (66,221)	\$ -		
43	End-of-Period Rate Base (L.34 thru L.42)	\$ (16,914)	\$ -		
Revenue Requirement Impact					
44.	Earnings required	\$ (1,836)	\$ -	\$ -	\$ -
45.	Earnings available	\$ 117,095	\$ 3,040	\$ 11,770	\$ 24,722
46.	Revenues required	\$ (202,847)	\$ (5,185)	\$ (20,075)	\$ (42,166)
47.	Rate of return	(32,339)			
48.	RUCO adjustments	(235,186)			
	RUCO adjustments - diff in rev req from USWC	(235,320)			
	diff	134			

RUCO Adjustments Summary

Line No.	Description	FCC			
		Universal Service Revenue	Reciprocal Compensation	Nonregulated/ ACC Regulated Imputation/Loss Adjustment	Broadband Revenues and Expenses
		E-4	E-5	E-6	E-7
Revenues					
1	Local Service Revenues	\$ -	\$ (1,371)		
2	Network Access Service Revenues				
3	Long Distance Network Service Rev.				
4	Miscellaneous			\$ 3,520	\$ 3,657
5	Total Oper. Rev. (L1 thru L4)	\$ -	\$ (1,371)	\$ 3,520	\$ 3,657
Expenses					
6	Maintenance				\$ 2,068
7	Engineering Expense				
8	Network Operations				
9	Network Administration				
10	Access Expense		\$ (2,886)		
11	Other				
12	Total Cost of Svcs & Products(L6 thru L11)	\$ -	\$ (2,886)	\$ -	\$ 2,068
13	Customer Operations				
14	Corporate Operations				
15	Property & Other Taxes		\$ (3)	\$ 4	
16	Uncollectibles		\$ (54)	\$ 65	
17	Tot Selling, Gen. & Admin.(L13 thru L16)	\$ -	\$ (57)	\$ 69	\$ -
18	Other Operating Income & Expense				
19	Depreciation Expense				
20	Universal Service Fund	\$ 1,370		\$ -	
21	Link Up America				
22	Total Operating Expense(L12+L17 thru L21)	\$ 1,370	\$ (2,943)	\$ 69	\$ 2,068
23	Income From Operations (L5-L22)	\$ (1,370)	\$ 1,572	\$ 3,451	\$ 1,589
Taxes					
24	Federal Income Tax	\$ (441)	\$ 506	\$ 1,111	\$ 512
25	State & Local Income Tax	\$ (110)	\$ 126	\$ 276	\$ 127
26	Net Operating Income (L23-L24-L25)	\$ (819)	\$ 940	\$ 2,064	\$ 950
Other					
27	Nonoperating Income & Expense				
28	Nonoperating Income Tax				
29	Net Operating Earnings (L26-L27-L28)	\$ (819)	\$ 940	\$ 2,064	\$ 950
30	Interest Expense				
31	Juris Diff & Nonreg Net Income				
32	Extraordinary Items				
33	Net Income (L29-L30-L31-L32)	\$ (819)	\$ 940	\$ 2,064	\$ 950
Rate Base					
34	Telephone Plant In Service				\$ 10,191
35	Short-Term Plant Under Construction				
36	Materials and Supplies				
37	Allowance for Cash Working Capital				
38	Accumulated Depreciation & Amortization Resen				\$ (3,400)
39	Accumulated Deferred Income Tax				
40	Customer Deposits				
41	Land Development Agreement Deposits				
42	Other Assets & Liabilities				
43	End-of-Period Rate Base (L.34 thru L.42)	\$ -	\$ -	\$ -	\$ 6,791
Revenue Requirement Impact					
44.	Earnings required	\$ -	\$ -	\$ -	\$ 738
45.	Earnings available	\$ (819)	\$ 940	\$ 2,064	\$ 950
46.	Revenues required	\$ 1,397	\$ (1,603)	\$ (3,520)	\$ (362)
47.	Rate of return				
48.	RUCO adjustments				
	RUCO adjustments - diff in rev req from USWC diff				

RUCO Adjustments Summary

Line No.	Description	Adjustment to Intrastate Depreciation Expense E-8	Investment Tax Credit Amortization E-9	Remove Pension Asset from Rate Base E-10	Wages and Salaries - Test Year E-11
Revenues					
1	Local Service Revenues				
2	Network Access Service Revenues				
3	Long Distance Network Service Rev.				
4	Miscellaneous				
5	Total Oper. Rev. (L1 thru L4)	\$ -		\$ -	
Expenses					
6	Maintenance				
7	Engineering Expense				
8	Network Operations				
9	Network Administration				
10	Access Expense				
11	Other				
12	Total Cost of Svcs & Products(L6 thru L11)	\$ -		\$ -	
13	Customer Operations				
14	Corporate Operations				
15	Property & Other Taxes				
16	Uncollectibles				
17	Tot Selling, Gen. & Admin.(L13 thru L16)	\$ -		\$ -	
18	Other Operating Income & Expense				
19	Depreciation Expense	\$ (8,905)			
20	Universal Service Fund				
21	Link Up America				
22	Total Operating Expense(L12+L17 thru L21)	\$ (8,905)		\$ -	
23	Income From Operations (L5-L22)	\$ 8,905		\$ -	
Taxes					
24	Federal Income Tax	\$ 2,867		\$ -	
25	State & Local Income Tax	\$ 712		\$ -	
26	Net Operating Income (L23-L24-L25)	\$ 5,326		\$ -	
Other					
27	Nonoperating Income & Expense				
28	Nonoperating Income Tax				
29	Net Operating Earnings (L26-L27-L28)	\$ 5,326		\$ -	
30	Interest Expense				
31	Juris Diff & Nonreg Net Income				
32	Extraordinary Items				
33	Net Income (L29-L30-L31-L32)	\$ 5,326		\$ -	
Rate Base					
34	Telephone Plant In Service				
35	Short-Term Plant Under Construction				
36	Materials and Supplies				
37	Allowance for Cash Working Capital				
38	Accumulated Depreciation & Amortization Resen				
39	Accumulated Deferred Income Tax			\$ 26,621	
40	Customer Deposits				
41	Land Development Agreement Deposits				
42	Other Assets & Liabilities			\$ (66,221)	
43	End-of-Period Rate Base (L.34 thru L.42)	\$ -		\$ (39,600)	
Revenue Requirement Impact					
44.	Earnings required	\$ -	\$ -	\$ (4,301)	\$ -
45.	Earnings available	\$ 5,326	\$ 328	\$ -	\$ 12,023
46.	Revenues required	\$ (9,084)	\$ (559)	\$ (7,336)	\$ (20,506)
47.	Rate of return				
48.	RUCO adjustments				
	RUCO adjustments - diff in rev req from USWC diff				

RUCO Adjustments Summary

Line No.	Description	Incentive Compensation	Management Wages and Salaries - Post Test Year	Occupational Wages and Salaries - Post Test Year	Software Capitalization - SOP 98-1
		E-12	E-13	E-14	E-15
	Revenues				
1	Local Service Revenues				
2	Network Access Service Revenues				
3	Long Distance Network Service Rev.				
4	Miscellaneous				
5	Total Oper. Rev. (L1 thru L4)				
	Expenses				
6	Maintenance				
7	Engineering Expense				
8	Network Operations				
9	Network Administration				
10	Access Expense				
11	Other				
12	Total Cost of Svcs & Products(L6 thru L11)				
13	Customer Operations				
14	Corporate Operations				
15	Property & Other Taxes				
16	Uncollectibles				
17	Tot Selling, Gen. & Admin.(L13 thru L16)				
18	Other Operating Income & Expense				
19	Depreciation Expense				
20	Universal Service Fund				
21	Link Up America				
22	Total Operating Expense(L12+L17 thru L21)				
23	Income From Operations (L5-L22)				
	Taxes				
24	Federal Income Tax				
25	State & Local Income Tax				
26	Net Operating Income (L23-L24-L25)				
	Other				
27	Nonoperating Income & Expense				
28	Nonoperating Income Tax				
29	Net Operating Earnings (L26-L27-L28)				
30	Interest Expense				
31	Juris Diff & Nonreg Net Income				
32	Extraordinary Items				
33	Net Income (L29-L30-L31-L32)				
	Rate Base				
34	Telephone Plant In Service				
35	Short-Term Plant Under Construction				
36	Materials and Supplies				
37	Allowance for Cash Working Capital				
38	Accumulated Depreciation & Amortization Resen				
39	Accumulated Deferred Income Tax				
40	Customer Deposits				
41	Land Development Agreement Deposits				
42	Other Assets & Liabilities				
43	End-of-Period Rate Base (L.34 thru L.42)				
	Revenue Requirement Impact				
44.	Earnings required	\$ -	\$ -	\$ -	\$ 2,489
45.	Earnings available	\$ 3,256	\$ 363	\$ 797	\$ 24,422
46.	Revenues required	\$ (5,553)	\$ (619)	\$ (1,359)	\$ (37,409)
47.	Rate of return				
48.	RUCO adjustments				
	RUCO adjustments - diff in rev req from USWC diff				

RUCO Adjustments Summary

Line No.	Description	Split Public Policy Organization Costs Between Ratepayers and Shareholders	Remove Non-Product Advertising Expense	Normalize Product Advertising Expense	Remove Sports Team Sponsorships Expense
		E-16	E-17	E-18	E-19
	Revenues				
1	Local Service Revenues				
2	Network Access Service Revenues				
3	Long Distance Network Service Rev.				
4	Miscellaneous				
5	Total Oper. Rev. (L1 thru L4)	\$ -			
	Expenses				
6	Maintenance				
7	Engineering Expense				
8	Network Operations				
9	Network Administration				
10	Access Expense				
11	Other				
12	Total Cost of Svcs & Products(L6 thru L11)	\$ -			
13	Customer Operations				
14	Corporate Operations	\$ (822)			
15	Property & Other Taxes				
16	Uncollectibles				
17	Tot Selling, Gen. & Admin.(L13 thru L16)	\$ (822)			
18	Other Operating Income & Expense				
19	Depreciation Expense				
20	Universal Service Fund				
21	Link Up America				
22	Total Operating Expense(L12+L17 thru L21)	\$ (822)			
23	Income From Operations (L5-L22)	\$ 822			
	Taxes				
24	Federal Income Tax	\$ 265			
25	State & Local Income Tax	\$ 66			
26	Net Operating Income (L23-L24-L25)	\$ 491			
	Other				
27	Nonoperating Income & Expense				
28	Nonoperating Income Tax				
29	Net Operating Earnings (L26-L27-L28)	\$ 491			
30	Interest Expense				
31	Juris Diff & Nonreg Net Income				
32	Extraordinary Items				
33	Net Income (L29-L30-L31-L32)	\$ 491			
	Rate Base				
34	Telephone Plant In Service				
35	Short-Term Plant Under Construction				
36	Materials and Supplies				
37	Allowance for Cash Working Capital				
38	Accumulated Depreciation & Amortization Resen				
39	Accumulated Deferred Income Tax				
40	Customer Deposits				
41	Land Development Agreement Deposits				
42	Other Assets & Liabilities				
43	End-of-Period Rate Base (L.34 thru L.42)	\$ -			
	Revenue Requirement Impact				
44.	Earnings required	\$ -	\$ -	\$ -	\$ -
45.	Earnings available	\$ 491	\$ 2,079	\$ 436	\$ 3,754
46.	Revenues required	\$ (837)	\$ (3,546)	\$ (744)	\$ (6,403)
47.	Rate of return				
48.	RUCO adjustments				
	RUCO adjustments - diff in rev req from USWC diff				

RUCO Adjustments Summary

Line No.	Description	Remove Olympic Sponsorship Expense E-20	Remove Out-Of-Period Income Tax Expense E-21	Reflect Sharing of Gain on Sale of 38 Arizona Exchanges with Traffic E-22	Service Quality Plan E-23
Revenues					
1	Local Service Revenues				
2	Network Access Service Revenues				
3	Long Distance Network Service Rev.				
4	Miscellaneous				
5	Total Oper. Rev. (L1 thru L4)		\$ -		
Expenses					
6	Maintenance				
7	Engineering Expense				
8	Network Operations				
9	Network Administration				
10	Access Expense				
11	Other				
12	Total Cost of Svcs & Products(L6 thru L11)		\$ -		
13	Customer Operations				
14	Corporate Operations		\$ -		
15	Property & Other Taxes				
16	Uncollectibles				
17	Tot Selling, Gen. & Admin.(L13 thru L16)		\$ -		
18	Other Operating Income & Expense				
19	Depreciation Expense				
20	Universal Service Fund				
21	Link Up America				
22	Total Operating Expense(L12+L17 thru L21)		\$ -		
23	Income From Operations (L5-L22)		\$ -		
Taxes					
24	Federal Income Tax		\$ (2,159)		
25	State & Local Income Tax		\$ 768		
26	Net Operating Income (L23-L24-L25)		\$ 1,391		
Other					
27	Nonoperating Income & Expense				
28	Nonoperating Income Tax				
29	Net Operating Earnings (L26-L27-L28)		\$ 1,391		
30	Interest Expense				
31	Juris Diff & Nonreg Net Income				
32	Extraordinary Items				
33	Net Income (L29-L30-L31-L32)		\$ 1,391		
Rate Base					
34	Telephone Plant In Service				
35	Short-Term Plant Under Construction				
36	Materials and Supplies				
37	Allowance for Cash Working Capital				
38	Accumulated Depreciation & Amortization Resen				
39	Accumulated Deferred Income Tax				
40	Customer Deposits				
41	Land Development Agreement Deposits				
42	Other Assets & Liabilities				
43	End-of-Period Rate Base (L.34 thru L.42)		\$ -		
Revenue Requirement Impact					
44.	Earnings required	\$ -	\$ -	\$ -	\$ -
45.	Earnings available	\$ 846	\$ 1,391	\$ 13,447	\$ 5,887
46.	Revenues required	\$ (1,443)	\$ (2,372)	\$ (22,935)	\$ (10,041)
47.	Rate of return				
48.	RUCO adjustments				
	RUCO adjustments - diff in rev req from USWC				
	diff				

RUCO Adjustments Summary

Line No.	Description	Cash Working Capital - Adjust to US WEST		Interest Synchronization Adjustment
		Calculated Rate Base Amount		
		E-24		E-25
	Revenues			
1	Local Service Revenues			
2	Network Access Service Revenues			
3	Long Distance Network Service Rev.			
4	Miscellaneous			
5	Total Oper. Rev. (L1 thru L4)	\$ -	\$ -	
	Expenses			
6	Maintenance			
7	Engineering Expense			
8	Network Operations	\$ -		
9	Network Administration			
10	Access Expense			
11	Other			
12	Total Cost of Svcs & Products(L6 thru L11)	\$ -	\$ -	
13	Customer Operations	\$ -		
14	Corporate Operations	\$ -		
15	Property & Other Taxes			
16	Uncollectibles			
17	Tot Selling, Gen. & Admin.(L13 thru L16)	\$ -	\$ -	
18	Other Operating Income & Expense			
19	Depreciation Expense			
20	Universal Service Fund			
21	Link Up America			
22	Total Operating Expense(L12+L17 thru L21)	\$ -	\$ -	
23	Income From Operations (L5-L22)	\$ -	\$ -	
	Taxes			
24	Federal Income Tax	\$ -	\$ 335	
25	State & Local Income Tax	\$ -	\$ 83	
26	Net Operating Income (L23-L24-L25)	\$ -	\$ (418)	
	Other			
27	Nonoperating Income & Expense			
28	Nonoperating Income Tax			
29	Net Operating Earnings (L26-L27-L28)	\$ -	\$ (418)	
30	Interest Expense			
31	Juris Diff & Nonreg Net Income			
32	Extraordinary Items			
33	Net Income (L29-L30-L31-L32)	\$ -	\$ (418)	
	Rate Base			
34	Telephone Plant In Service			
35	Short-Term Plant Under Construction			
36	Materials and Supplies			
37	Allowance for Cash Working Capital	\$ (7,021)		
38	Accumulated Depreciation & Amortization Resen			
39	Accumulated Deferred Income Tax			
40	Customer Deposits			
41	Land Development Agreement Deposits			
42	Other Assets & Liabilities			
43	End-of-Period Rate Base (L.34 thru L.42)	\$ (7,021)	\$ -	
	Revenue Requirement Impact			
44.	Earnings required	\$ (762)	\$ -	
45.	Earnings available	\$ -	\$ (418)	
46.	Revenues required	\$ (1,300)	\$ 713	
47.	Rate of return			
48.	RUCO adjustments			
	RUCO adjustments - diff in rev req from USWC diff			

U S WEST COMMUNICATIONS, INC
ARIZONA INTRASTATE OPERATIONS
TEST YEAR ENDING December 31, 1999
(IN THOUSANDS OF DOLLARS)
Adjustment for Reciprocal Compensation

Exhibit ____ (L&A - 2)
Docket No. T-1051B-99-105
Schedule E-5

Line No.	Description	USWC Reciprocal Compensation Automatic Adjustment Clause (A)	Reciprocal Compensation Test Year Amounts (B)	Reciprocal Compensation Adjustment (C)
Revenues				
1	Local Service Revenues	\$ 7,932	\$ 6,561	\$ (1,371)
2	Network Access Service Revenues			
3	Long Distance Network Service Rev.			
4	Miscellaneous			
5	Total Oper. Rev. (L1 thru L4)	\$ 7,932	\$ 6,561	\$ (1,371)
Expenses				
6	Maintenance			
7	Engineering Expense			
8	Network Operations			
9	Network Administration			
10	Access Expense	\$ 20,522	\$ 17,636	\$ (2,886)
11	Other			
12	Total Cost of Svcs & Products(L6 thru L11)	\$ 20,522	\$ 17,636	\$ (2,886)
13	Customer Operations			
14	Corporate Operations			
15	Property & Other Taxes	\$ 23	\$ 20	\$ (3)
16	Uncollectibles	\$ 380	\$ 326	\$ (54)
17	Tot Selling, Gen. & Admin.(L13 thru L16)	\$ 403	\$ 346	\$ (57)
18	Other Operating Income & Expense			
19	Depreciation Expense			
20	Universal Service Fund			
21	Link Up America			
22	Total Operating Expense(L12+L17 thru L21)	\$ 20,925	\$ 17,982	\$ (2,943)
23	Income From Operations (L5-L22)	\$ (12,993)	\$ (11,421)	\$ 1,572
Taxes				
24	Federal Income Tax	\$ (4,184)	\$ (3,678)	\$ 506
25	State & Local Income Tax	\$ (1,039)	\$ (914)	\$ 125
26	Net Operating Income (L23-L24-L25)	\$ (7,770)	\$ (6,829)	\$ 941
Other				
27	Nonoperating Income & Expense			
28	Nonoperating Income Tax			
29	Net Operating Earnings (L26-L27-L28)	\$ (7,770)	\$ (6,829)	\$ 941
30	Interest Expense			
31	Juris Diff & Nonreg Net Income			
32	Extraordinary Items			
33	Net Income (L29-L30-L31-L32)	\$ (7,770)	\$ (6,829)	\$ 941

Source

Col.A Workpapers used to derive "Per Company" amounts, on Column A of Schedule C in RUCO Exhibit __ (L&A-1)
Col.B Company adjustment workpapers. Amounts through line 23 agree with ACC Staff Schedule C-30.
These are the recorded test year Reciprocal Compensation amounts.
Col.C Col.B less Col.A

US West Communications, Inc. -- Arizona
Test Year Ended December 31, 1999
(IN THOUSANDS OF DOLLARS)

Exhibit ____ (L&A - 2)
Docket No. T-1051B-99-105
Schedule E-6

Adjustment for FCC Deregulated Services Revenue Imputation

Line No.	Description	Amount	Reference
1	Rate base, FCC Deregulated per USWC direct filing	\$ 18,914	ACC Staff Sch. C-17, note (b)
2	RUCO proposed rate of return	9.51%	Schedule D
3	NOI required	\$ 1,799	L.1 x L.2
4	NOI available	\$ (265)	ACC Staff Sch. C-17, Col.D
5	NOI deficiency	\$ 2,064	L.3 - L.4
6	Gross Revenue Conversion Factor	1.7056	Schedule A-1
7	Revenue Imputation	\$ 3,520	L.5 x L.6

US West Communications, Inc. -- Arizona
Test Year Ended December 31, 1999
(IN THOUSANDS OF DOLLARS)

Exhibit ____ (L&A - 2)
Docket No. T-1051B-99-105
Schedule E-7

Adjustment for Broadband Cable TV Revenue, Expense and Asset Transfer

Line No.	Description	Amount	Reference
Rate Base			
1	Plant in Service, asset transfer	\$ 10,191	ACC Staff Sch. B-6, Col.D
2	Accumulated Depreciation	\$ (3,400)	ACC Staff Sch. B-6, Col.D
3	Net Plant in Service	<u>\$ 6,791</u>	ACC Staff Sch. B-6, Col.D
Revenues - Services Provided to BSI			
4	Revenue annualization	<u>\$ 3,657</u>	ACC Staff Sch. C-6, Col.D
Expense Credits - Services Provided to BSI			
5	Annualization	\$ (822)	ACC Staff Sch. C-6, Col.D
6	Remove duplicate affiliate billings	\$ 2,890	UTI 43-20A
7	Test year expenses	<u>\$ 2,068</u>	
8	Pre-tax operating income	<u><u>\$ 1,589</u></u>	L.4 - L.7

U S WEST COMMUNICATIONS, INC
ARIZONA INTRASTATE OPERATIONS
TEST YEAR ENDING December 31, 1999

Docket No. T-1051B-99-105
Schedule E-24 Revised
Page 1 of 1

Cash Working Capital - Adjust to US WEST Calculated Rate Base Amount

Line No.	Description	Amount (A)	Reference
1	Cash Working Capital - Arizona Intrastate Amount Amount calculated by US WEST with Commission adjustments and fully adjusted test year, Commission Basis Cash Working Capital	\$ (46,232)	Attachment RCS-S1
2	Amount reflected in adjusted rate base in US WEST's filing	\$ (39,211)	Note A
3	Adjustment to cash working capital	\$ (7,021)	

Notes

[A] May 3, 2000 Supplemental Exhibits of George Redding, GAR-S4

U S WEST COMMUNICATIONS, INC.
Arizona Intrastate Operations
Test Year Ending December 31, 1999
(In Thousands of Dollars)

Docket No. T-1051B-99-105
Schedule E-25 Revised
Page 1 of 1

Interest Synchronization

Line No.	Description	Amount	Reference
1	Rate base	\$ 1,404,500	Schedule B Revised
2	Weighted cost of debt	3.49%	Schedule D
3	Synchronized interest deduction	\$ 49,017	L.1 x L.2
4	Interest in Company's filing	\$ 50,058	Note A
5	Difference in interest	\$ (1,041)	L.3 - L.4
6	Effective Federal Income Tax Rate	32.2000%	Note A
7	Federal Income Tax Expense	\$ 335	-(L.5) x L.6
8	Effective State Income Tax Rate	8.0000%	Note A
9	State Income Tax Expense	\$ 83	-(L.5) x L.8
10	Increase (decrease) to income tax expense	\$ 418	L.7 + L.9

Notes

- A USWC response to UTI 42-1, interest synchronization workpapers
B Schedule A-1

Before the
Arizona Corporation Commission

In the Matter of the Application of US West)
Communications, Inc., A Colorado Corporation,)
for a hearing to determine the earnings of the)
company, the fair value of the company for rate-)
making purposes, to fix a just and reasonable rate)
of return thereon and to approve rate schedules)
_____)

DOCKET NO. T-01051B-99-0105

Surrebuttal Testimony of

JOHN B. LEGLER

On Behalf of the

RESIDENTIAL UTILITY CONSUMER OFFICE

September 8, 2000

1 SURREBUTTAL TESTIMONY OF
2 JOHN B. LEGLER
3 BEFORE THE
4 ARIZONA CORPORATION COMMISSION
5 DOCKET NO. T-1051B-99-105
6

7 **Q. WHAT IS YOUR NAME AND ADDRESS?**

8 A. John B. Legler, my business address is 1040 St. Andrews Court, Bogart,
9 Georgia, 30622.
10

11 **Q. ARE YOU THE SAME JOHN B. LEGLER WHO HAS PREVIOUSLY FILED**
12 **DIRECT TESTIMONY IN THIS PROCEEDING?**

13 A. Yes, I am. A statement of my credentials and experience is contained in
14 my direct testimony.
15

16 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY AT THIS TIME?**

17 A. I am responding to comments of Mr. Peter C. Cummings regarding my
18 testimony, and in a limited manner, the testimony of Mr. Charles W. King,
19 and Mr. Stephen G. Hill.
20
21
22

1 Q. DO YOU AGREE WITH MR. CUMMINGS THAT THE COST OF EQUITY
2 RECOMMENDATIONS OF MR. KING, MR. HILL, AND YOURSELF ARE TOO
3 LOW?

4 A. No, I do not agree with Mr. Cummings' assessment of our testimonies
5 and recommendations. Recognizing that all three of us exercised our
6 professional judgments, I find the range of our recommendations
7 surprisingly close. Mr. King and I both recommend a point estimate of
8 11.5% and Mr. Hill recommends 11.75%.

9
10 Q. DO YOU AGREE WITH ANY OF MR. CUMMINGS COMMENTS REGARDING
11 THE TESTIMONIES OF MR. KING, MR. HILL, AND YOURSELF?

12 A. Yes, I do. I agree with him that the Company's updated capital structure
13 and embedded cost of debt are acceptable for purposes of estimating the
14 cost of capital. I further agree that telephone companies are an
15 appropriate group to use in the analysis of the cost of equity. I agree
16 with him the use of other groups of companies, electric utilities, gas
17 distributors and insurance companies are inappropriate for purposes of
18 estimating the cost of equity to U S West (QWEST) and not comparable in
19 riskiness to telephone companies. I also agree, that the arithmetic
20 means rather than geometric means should be used in calculating risk
21 premiums.

1
2 Q. DO YOU AGREE WITH MR. CUMMINGS REGARDING THE TECHNICAL
3 ASPECTS OF THE ESTIMATING METHODS USED BY MR. KING AND MR.
4 HILL?

5 A. I have not reviewed the testimonies of Mr. King and Mr. Hill and I am not
6 prepared to comment on them.
7

8 Q. DO YOU AGREE WITH MR. CUMMINGS' COMMENTS REGARDING YOUR
9 TESTIMONY?

10 A. No, I do not.
11

12 Q. PLEASE EXPLAIN.

13 A. For consistency, I have used the same methods in my testimony before
14 commissions for many years. Therefore, I included all of my estimates
15 which admittedly produce an apparent wide range of estimates. I chose
16 to include all of my estimates rather than eliminate companies from the
17 sample or methods of estimating the cost of equity. I agree with him
18 that extremely low estimates (those below the cost of a company's debt)
19 should be eliminated. For this reason, estimates below 8.2% from the
20 DCF method were eliminated from consideration in making my
21 recommendation.
22

1 Mr. Cummings is correct that my recommendation was based primarily
2 on my risk premium and CAPM results. Although I used the DCF method
3 in my analysis in the same manner as I have in other cases, I found the
4 range produced by that method is too broad to be of much value. This is
5 attributable to the broad range of growth rates. Value Line's direct
6 estimate of dividend growth is rather low, on average, and retention
7 growth estimated from Value Line data is rather high. The required
8 growth rate in the DCF model is a long-term sustainable growth rate, and
9 for the reasons set forth in my direct testimony, I find growth rates in
10 excess of 6 percent require unsustainable growth in either the payout
11 ratio or the return on equity or both.

12
13 My comments regarding each of the methods, DCF, Risk Premium, and
14 CAPM are meant to express the limitations of the models, and not to
15 suggest that they should be eliminated from consideration in making a
16 recommendation. I believe that my comments regarding the limitations
17 of the models is consistent with my basis for arriving at my
18 recommendation.

19
20 **Q. DO YOU AGREE WITH MR. CUMMINGS' COMMENTS REGARDING YOUR**
21 **RISK PREMIUM ANALYSIS?**

22 **A.** No, I do not. As stated by Mr. Cummings I based my analysis on two

1 studies of the risk premium. One study was for U S WEST and the other
2 was for independent telephone companies. My purpose in doing the
3 studies was to arrive at forward looking premiums rather than historical
4 risk premiums. The current yield on bonds is a forward looking yield. It
5 is the yield an investor will obtain if the bond is held to maturity. My
6 DCF (and CAPM) estimates of the cost of equity are forward looking, and
7 the resulting risk premiums are forward looking. Mr. Cummings is
8 correct that I removed negative or near zero risk premiums not from
9 1994 forward, but for all years. His criticism that my estimating method
10 produced single digit equity costs since the second quarter of 1993 is
11 inappropriate since these estimates produces negative risks premiums
12 which I eliminated.

13
14 Mr. Cummings calls my independent telephone companies risk premium
15 study a "black box" since I did not identify the companies or how I
16 calculated the dividend yields and growth rates or weighted them. The
17 companies consist of the group of major independent telephone
18 companies which have changed somewhat with mergers over the years,
19 and the methods for calculating the dividend yields and growth rates are
20 the same as in my DCF analysis. The calculated risk premiums for the
21 1995-1999 time period indicate extreme values 9.93% based on
22 retention growth and 1.07% based on Value Line growth which is why I

1 based my risk premium analysis on longer-term average premiums.

2
3 **Q. MR. CUMMINGS STATES THAT THERE IS AN ALTERNATIVE SOURCE OF**
4 **RISK PREMIUMS, AND CITES THE IBBOTSON ASSOCIATES STUDY. DO**
5 **YOU AGREE WITH HIS COMMENTS?**

6 A. No, I do not. While I agree that the Ibbotson study is used by analysts, it
7 is commonly used by analysts in implementing the CAPM. The difference
8 between long-term stock returns and long-term bond returns is often
9 used as a measure of the risk premium for average risk stocks. Frankly, I
10 do not know where Mr. Cummings got his risk premium of 7.4% as
11 shown on page 38, line 6 of his rebuttal testimony. I believe that the
12 most recent average difference between arithmetic stock and bond
13 returns is over 8%. To estimate the cost of equity for any particular
14 company would require an adjustment to the market risk premium (his
15 figure of 7.4%). This adjustment factor is beta. Since telephone betas
16 are generally less than 1.0 (the beta of an average risk company), the
17 resulting cost of equity would be lower than Mr. Cummings asserts.

18
19 **Q. MR. CUMMINGS ALSO CRITICIZES YOUR CAPM ANALYSIS, DO YOU**
20 **AGREE WITH HIS CRITICISM?**

21 A. No, I do not. Mr. Cummings criticism is based on my use of both
22 unadjusted and adjusted betas. The unadjusted betas are from Standard

1 & Poor's and the adjusted betas are from Value Line. Contrary to Mr.
2 Cummings assertion, I did not mix these betas, but separated them and
3 base my CAPM results on separate sets of betas. In my direct testimony,
4 I explain the difference between these two beta concepts and show how I
5 arrived at my CAPM estimates.
6

7 CONCLUSION AND RECOMMENDATION

8 **Q. WHAT IS YOUR RECOMMENDATION FOR A FAIR RETURN ON EQUITY**
9 **FOR U S WEST (QWEST)?**

10 A. My recommendation remains at 11.5%. I find most of Mr. Cummings
11 criticisms of my testimony to be without merit, and my recommendation
12 is supported by the other witnesses on the cost of capital, Mr. King and
13 Mr Hill. We all agree that the Company's updated capital structure and
14 embedded cost of debt is reasonable.
15

16 **Q. WHAT IS YOUR RECOMMENDATION FOR A FAIR OVERALL RETURN ON**
17 **RATE BASE FOR U S WEST (QWEST)?**

18 A. Based on the Company's capital structure and embedded debt cost, my
19 recommendation for a fair overall return on rate base is 9.55%.
20

21 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

22 A. Yes, it does.

SEP 08 2003



BEFORE THE ARIZONA CORPORATION COMMISSION

In the Matter of the Application of US West Communications, Inc., a Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules.

Docket Number: T-01051B-99-0105

Surrebuttal Testimony of Ben Johnson, Ph.D.

Witness for the State of Arizona Residential Utilities Consumer Office

TABLE OF CONTENTS

Introduction	1
Shared Costs	3
Cost Causation	5
Joint Production vs. Joint Consumption	8
Access vs. Usage	11
Withdrawal of Local Service	15
Competition and Pricing	18
TSLRIC as a Price Floor	18
Rule Changes	20
Market Share	23
Rate Design	34

1
2 TESTIMONY
3 OF BEN JOHNSON, PH.D.
4 On Behalf of
5 THE STATE OF ARIZONA
6 RESIDENTIAL UTILITY CONSUMER OFFICE
7 Before the
8 ARIZONA CORPORATION COMMISSION
9

10 Docket No. T-01051B-99-0105
11

12 **Introduction**
13

14 **Q. Would you please state your name and address?**

15 A. Ben Johnson, 2252 Killearn Center Boulevard, Tallahassee, Florida 32308.
16

17 **Q. What is your purpose in submitting this testimony?**

18 A. In this surrebuttal testimony I will be responding to certain portions of the rebuttal
19 testimony of Qwest witnesses William Taylor, David Teitzel, and Jerrold Thompson. The
20 fact that I do not discuss other positions taken by these witnesses, or the positions taken
21 by other witnesses, should not be construed as agreement with such undiscussed
22 positions.
23

24 **Q. Would you please explain how your surrebuttal testimony is organized, and briefly
25 summarize its major elements?**

26 A. Yes. Following this introduction, my testimony has three major sections. The first section
27 contains a discussion of shared costs. I respond to the arguments made by Qwest
28 witnesses concerning the principle of cost causation, and demonstrate that these do not
29 justify their treatment of loop costs. I will also address the distinction between joint

1 production and joint consumption, and the distinction between network access and local
2 usage. In addition, I will respond to Dr. Taylor's contention that loop costs could be
3 avoided if Qwest were to discontinue providing basic local exchange service while
4 continuing to provide all of its other services.

5 The second section contains a discussion of competition and pricing flexibility. I
6 explain why Qwest's competitive zone proposal is inappropriate because it would provide
7 too much freedom for the Company to engage in anti-competitive pricing and achieve
8 monopoly profits. I respond to Mr. Teitzel's discussion of total service long run
9 incremental costs ("TSLRIC") as price floors and the assertion that Qwest's profit
10 margins will be squeezed as a result of its pricing plan. Also, I discuss Mr. Teitzel's
11 reaction to my proposed rule revision, Dr. Taylor's call for the establishment of triggers,
12 and his complaint about burden of the evidentiary proceedings which are required to gain
13 increased pricing flexibility under the Commission's existing rules. Finally, the second
14 section contains a discussion of the importance of market share data in revealing a
15 carrier's market power. I reply to the Company's attempt to downplay any reliance on
16 market share in evaluating competitive conditions.

17 In the third and final section, I respond to the Company's critiques of my specific
18 rate design proposals. These are few in number, involving only my proposals for basic
19 local service and zone increment charges, as well as my proposed adjustment to toll
20 volumes due to price elasticity of demand. I also take the opportunity to reemphasize
21 some of the most important elements of my rate design recommendations which have not
22 been rebutted by Qwest witnesses.
23

1 **Shared Costs**

2
3 **Q. Please turn to the first section of your surrebuttal testimony, concerning shared**
4 **costs and their relevance to the policy issues involved in rate making. To begin,**
5 **would you please respond to the contention of US West witness Dr. Taylor that your**
6 **views on this topic reflect a "time-honored economic fallacy"?**

7 **A.** Yes. Staff witness Bill Dunkel and I have recommended that the Commission treat loop
8 and port costs as shared costs, which are properly recoverable from all services using the
9 loop and the port. Realizing that our view of this topic is shared by many other
10 knowledgeable observers, and realizing that regulators in other jurisdictions have often
11 accepted our view and rejected the one put forth by the Qwest witnesses, Dr. Taylor
12 endeavors to dismiss our view with some rather sweeping rhetoric:

13
14 Dr. Johnson and Mr. Dunkel commit the time-honored economic fallacy of
15 allocating loop costs to services other than the basic exchange services in
16 which network access is bundled. ... Mr. Dunkel's conclusion is contrary
17 to sound economic principles and based on a misunderstanding of
18 economic costs and the cost recovery process. ... In contrast to Mr.
19 Dunkel's conclusion, economic principles dictate that the cost of a loop
20 should be recovered in the price of the service-network access-the demand
21 for which brought about the production of that loop. To recover the cost
22 of a loop based on any other principle would be a departure from sound
23 economic reasoning. [Taylor, Rebuttal, p. 4, 16]
24

25 Needless to say, both Mr. Dunkel and I have a clear understanding of the historic
26 processes by which costs have been recovered in this industry, and our views are not
27 based upon an incomplete or misguided understanding of the underlying economic
28 theory. Rather, we fundamentally disagree with Qwest's witnesses concerning the
29 appropriate way of interpreting these costs. As Dr. Taylor concedes, this has long been a
30 controversial topic, but Mr. Dunkel and I are certainly not alone in our views.

1 Despite years of advocacy efforts on the part of regional Bell operating companies,
2 AT&T and other major carriers, state and federal regulators have widely recognized that
3 loop costs are best treated as shared costs which are appropriately recovered from
4 multiple sources.

5 Even the FCC, in its recent orders regarding interconnection, access, and universal
6 service, has treated loop and port costs as shared costs of several services, not as direct
7 costs of local service. According to the FCC, the loop is "needed" and "used" by several
8 telecommunication services--including toll and access services which reside within the
9 interstate jurisdiction.

10 The shared nature of loop and port costs has also been recognized in decisions
11 issued by numerous state regulatory commissions, including the commissions of
12 Colorado, Florida, Iowa, Louisiana, Minnesota, New Hampshire, New Mexico,
13 Pennsylvania, Texas, Vermont, Virginia, and Washington, and confirmed by both the
14 National Association of Regulatory Utility Commissions (NARUC) and the National
15 Association of State Utility Consumer Advocates (NASUCA).

16 The conclusions I draw in this area are also consistent with Section 254(k) of the
17 1996 Telecommunications Act, whereas the approach advocated by Qwest--in which an
18 excessive share of the loop and port costs would be placed on basic local exchange
19 service--would not be consistent with those provisions of federal law.

20 I included a detailed discussion of this topic, including specific citations to
21 illustrative regulatory decisions in other jurisdictions, in Appendix C which is attached to
22 my direct testimony. If the Commission will carefully compare that appendix with
23 Qwest's rebuttal testimony, it will see that the reasoning set forth in the appendix remains
24 largely unchallenged by the Qwest witnesses. Certainly, the key elements of that
25 reasoning have not been successfully refuted by the Qwest witnesses.

26 I would also note that, contrary to Dr. Taylor's assertion, most of my testimony
27 did not involve "allocating loop costs to services other than the basic exchange services."

1 I provided the Commission with three different methods of analyzing these costs; only
2 one of these methods involved any allocation of loop costs to services other than basic
3 exchange.

4
5 *Cost Causation*

6
7 **Q. What evidence and/or argument has Dr. Taylor put forward to support his position**
8 **concerning this issue?**

9 **A.** Like a good conservationist, Dr. Taylor manages to recycle a well worn telecom
10 argument about "cost causation."

11
12 The fundamental principle is cost causation, that principle in economics
13 that aligns the price paid by a consumer with the costs incurred by society
14 to fulfill that consumer's demand. Simply put, cost causation provides the
15 answer to the question of why the resources used in providing the loop
16 have been expended. The costs associated with the loop are caused by a
17 customer gaining access to the network. Applying the principle of cost
18 causation leads directly to an efficient economic outcome which, in this
19 case, is that the cost of a loop should be assigned only to Qwest's local
20 exchange service, which is a bundled service consisting of local usage and
21 network access. [Taylor, Rebuttal, p. 17]

22
23 Dr. Taylor is arguing that because the access line is "bundled" with local usage, the cost
24 of the access line is effectively "caused" by the act of subscribing to local exchange
25 service, and that all other services that may be provided over the line can benefit from the
26 use of the line without any additional cost, and are thus economically irrelevant. Stated
27 another way, he is arguing that because you can't purchase local service usage (generally
28 unlimited) without getting a dial tone line and vice versa, from a cost-causation
29 standpoint that artifact of the tariff structure should control the analysis. Simply because
30 the line is provided by the phone company on a bundled basis, in conjunction with local

1 exchange service, it is argued that the full cost of that line should be attributed to the local
2 exchange category.

3
4 **Q. Do you accept this reasoning?**

5 A. No. To begin with, Dr. Taylor relies upon an overly simplistic view of causation, which
6 can result in misleading conclusions. In fact, if we want to really examine causation, it is
7 apparent that the cost of a local loop is incurred because someone--perhaps an aspiring
8 subscriber in years past, perhaps a real estate developer or home builder, perhaps a phone
9 company executive--made a decision to install loop plant along a particular route. Some
10 of this plant is dedicated to a particular neighborhood, or house, and other plant serves a
11 broader geographic area. The decisions that lead to the act of installing these facilities can
12 be seen as the proximate cause of the cost. Subsequently, if consumers don't decide to
13 purchase telephone service, the plant will often sit idle; if they do decide to purchase
14 service, it will be utilized.

15 The actual loop cost incurred by the phone company may not vary much either
16 way, regardless of whether or not a particular household decides to join the network.
17 Thus, his assumption that the loop costs set forth in Qwest's studies can be directly traced
18 to customer decisions to join the network is simply not valid. Most of these costs would
19 continue, regardless of whether or not particular customers purchase telephone service.
20 The costs which are specifically caused by individual customer decisions to join the
21 network are quite different from, and generally much lower than, the TSLRIC-type cost
22 figures put forward by Qwest in this proceeding.

23 In my direct testimony, I noted that the loop is bundled with local service. This
24 creates the appearance of a "cause and effect" linkage between demand for local service
25 and the amount of loop costs incurred by a carrier. I don't necessarily concede that a valid
26 causal relationship exists in this situation. But, regardless of whether or not loop costs are
27 truly "caused" by customer demand for local exchange service, this doesn't change the

1 fact that some of the loop and port costs can, and appropriately should, be recovered
2 through the prices charged for other services.

3 I explained this point at length in various portions of my direct testimony which
4 the Qwest witnesses have essentially ignored. For example, at page 59 of my direct
5 testimony, I pointed out that

6
7 Even if US West primarily installs local loops and ports in order to
8 provide local exchange service, that doesn't mean that the loop can't also
9 generate other sources of revenue. To the contrary, whenever additional
10 loops are added to its network in response to increased demand for basic
11 local exchange service, the Company is able to sell more switched access,
12 long distance, caller ID, call waiting, and other optional services to these
13 and other customers. Even if a chair-maker is primarily in business to
14 make chairs, it may be able to generate ancillary revenues from the sale of
15 wood shavings or sawdust. If so, these revenues would be treated as a
16 reduction in the total cost of producing chairs; they would not be ignored
17 or excluded from consideration in deciding how profitable the chair
18 business is.
19

20 It is also worth noting that despite their rhetoric about the importance of "cost causation,"
21 the Qwest witnesses do not actually advocate a consistent policy of designing rates to
22 reflect cost causation. To the contrary, many aspects of the Qwest rate proposals ignore
23 cost patterns, or are directly contrary to those patterns. For instance, the proposed
24 increases in Caller ID, premium listings, and various other items move these rates farther
25 above their direct costs. The costs which are directly "caused" by customers opting for
26 these services are extremely small—on the order of just pennies a month. Since the
27 existing rates already exceed the costs that are "caused" by subscribers to these services,
28 Qwest's proposed rate proposals move even farther out of alignment with cost causation
29 principals.

30 To the extent there is a common theme in the Company's proposals, it appears
31 that it is responding to perceived demand characteristics. Interestingly, demand

1 considerations are precisely what explains the recovery of joint or shared costs in
2 competitive industries. Purchasers contribute to the joint costs of production in amounts
3 that depend upon the strength of their demand. If demand for wood shavings is strong, the
4 price of chairs will likely go down, because some of the underlying wood costs will be
5 recouped from the sale of shavings. If the market for leather collapses due to competition
6 from plastic substitutes, the price of hamburger and steaks will go up. Similarly, if the
7 market for caller ID or call waiting were to drastically change, so that no one was willing
8 to pay extra for these services, they would be discontinued or given away for free, and the
9 price of the remaining services provided by the carrier would tend to increase.

10
11 *Joint Production vs. Joint Consumption*
12

13 **Q. Would you please respond to Dr. Taylor's contention that the loop should be viewed**
14 **as an "output of suppliers" and Mr. Thompson's belief that "shared use" of a loop**
15 **does not mean that it is a shared cost?**

16 **A.** Yes. The points made by these witnesses do not change or refute the conclusions I
17 reached in my direct testimony. Consider, for example, the definition of joint costs I
18 quoted from the Handbook of Industrial Organization ("HIO"), a standard reference work
19 edited by Schmalensee and Willig: joint costs arise when there are production factors that
20 "once acquired for use in producing one good... are costlessly available for use in the
21 production of others." This definition is consistent with the cattle feed used in producing
22 hamburgers and leather shoes, as well as the loop which is used in producing local and
23 toll services. If demand for hamburger increases, the cattle feed used in fulfilling this
24 demand will costlessly be available for use in producing more leather shoes. Similarly, if
25 the demand for basic local service increases, the loops which are used in fulfilling this
26 demand will costlessly be available for use in producing more toll service.
27

1 **Q. What about Dr. Taylor's distinction between inputs and outputs?**

2 A. I would concede that loops are both an output and an input, but this doesn't change the
3 underlying logic of the situation. Dr. Taylor states,

4
5 The fact that the loop is an output of suppliers and not simply an input into
6 the production of other telephone services distinguishes it from the
7 classical cases of joint costs such as hay producing beef and hides or
8 chicken feed producing egg yolks and whites.
9

10 In truth, most classic examples of joint costs are like loops in that they involve
11 intermediate outputs which are, in turn, used as inputs to the production of final goods
12 and services purchased by end users. Dr. Taylor implies that the loop is different than
13 cattle. Perhaps that is true, but the larger point he is trying to make is not true. I would
14 concede that the loop is an intermediate output. In this regard, it is different than cattle
15 feed, but it is more directly analogous to cows, which are grown using cattle feed. Most
16 consumers don't want to buy a loop any more than they want to buy a cow. Rather, they
17 want to purchase local and toll service, as well as hamburger and leather gloves.

18 It is not unreasonable to think of the loop as an intermediate output which is
19 produced using cable and telephone poles; in turn, this output can be viewed as an input
20 to the production of various services desired by customers. Similarly, cows can be viewed
21 as intermediate outputs which are produced using various sources of protein, minerals and
22 vitamins; in turn, this output can be viewed as an input into various goods desired by
23 customers, including steaks, hamburgers, shoes, and so forth.

24 Aside from complicating the discussion, however, this distinction changes
25 nothing. A typical loop only provides value when it is combined with other inputs (e.g.
26 switching hardware and software) to provide customers with local telephone service, toll
27 service, and custom calling services. Similarly, a cow typically only provides value when
28 it is combined with other inputs (e.g. butchering and tanning) to provide customers with

1 the actual goods that they desire. The key point is that where multiple goods and services
2 are obtained from common inputs, the revenues from those goods and services will all
3 contribute towards recovery of the underlying cost of the common inputs. The entirety of
4 these joint or shared costs will not be recovered exclusively through the price charged for
5 one of the ultimate outputs. In contrast, the final goods and services typically also involve
6 certain direct costs, which will exclusively be borne by purchasers of that item. For
7 instance, tanning costs will be exclusively borne by purchasers of leather goods and the
8 cost of grinding beef will be borne exclusively by purchasers of hamburgers.

9
10 **Q. Can you lend any additional insight into the local loop's role in joint production and**
11 **consumption of telephone services?**

12 **A.** Yes. The local loop enables a consumer to place local calls, toll calls, and have access to
13 a variety of custom calling features. Except when congestion is present, there is no
14 trade-off between these joint uses. In other words, when an additional access line is
15 installed, it simultaneously increases the intermediate output (access) available to both
16 toll and local markets (as well as the market for other services, such as custom calling),
17 fulfilling the HIO definition above.

18 Any confusion in this regard can be eliminated by further disaggregation and
19 study. Simply stated, completed toll calls typically involve three or more intermediate
20 steps: use of two access lines, one or more switches, and one or more interoffice trunks.
21 In turn, some of these components can be used only for local purposes, some only for toll,
22 and others for both purposes. Because of congestion, inter-office switching and trunking
23 typically involves either direct costs (when the item is dedicated to one market or the
24 other) or common costs (when the item is shared but increased use in one market
25 displaces usage in the other market). The access line is obviously either a joint or a
26 common cost, since it serves multiple markets. I believe it can most accurately be viewed
27 as a joint cost, in the typical situation where the line is not highly congested and use in

1 one market does not preclude use in the other market. Either way, it is a shared cost
2 which will properly be recovered in part from both toll and local services.

3 More specifically, the provision of an access line yields at least two intermediate
4 products: access to customers within the same locality (local access) and access to
5 customers within other cities (toll access). Since the latter form of access is provided via
6 toll carriers, one can think of the access line as providing access to local and toll
7 networks. Of course, since communication is generally two-way, we can also say that two
8 other joint products are provided, as well: access to the customer installing the line by
9 other customers within the same locality, and access to that customer by toll carriers and
10 their customers. Similarly, when used in conjunction with modern switching hardware
11 and software, an access line also provides access to other useful services, like call waiting
12 and voice mail.

13
14 *Access vs. Usage*

15
16 **Q. What is the difference between network access and usage?**

17 **A.** Mr. Thompson states that "the costs of Basic Service should be viewed as consisting of
18 two services, access and usage." As a theoretical matter, one can certainly make this
19 distinction. However, as a practical matter, most customers do not think about, or seek
20 "network access" separate and apart from the telephone services which make this access
21 useful. For the average consumer, having "access" to local and long distance networks is
22 only beneficial if they also "use" those networks. Thus, it is hardly surprising that
23 customers generally don't pay for "access" separate and apart from the "usage" which
24 enables that access to provide them with valuable communications.

25 In a wholesale context, it is certainly true that "access" (or access lines) can be
26 viewed as a separate product, as has been suggested by Mr. Thompson. However, this
27 distinction does not "solve" the joint cost problem, nor does it create a justification for

1 placing all of the loop costs on local service and providing toll carriers with free use of
2 those loops. Even if we accept the notion of charging separately for "access," it does not
3 change the fundamental nature of the situation. To the contrary, the product thereby
4 defined is more appropriately seen as an intermediate product that is ultimately used in
5 two or more markets. The joint characteristics do not simply disappear. In fact, Qwest
6 routinely charges toll carriers like AT&T and MCI for "access" to its customers. The fees
7 it collects help recover the cost of the loops which are used in providing that access.
8 Similarly, if one defines the product being produced from cattle feed as "cows," this
9 doesn't change the fact that cattle feed is a joint cost that impacts both the beef and leather
10 markets. Nor does it change the fact that the cost of the cattle feed (or the cost of the
11 intermediate product called "cattle") is ultimately borne by purchasers of both beef and
12 leather. "Access" is provided in both directions; it involves lines situated within the same
13 city, as well as toll carriers who have points of presence in that city. Via their facilities,
14 "access" is provided in both directions to millions of lines located in hundreds of other
15 cities around the state, nation, and planet. There is no logical reason why the entire
16 burden of the loop costs involved in providing this "access" must be borne by the
17 residence which connects to the network, as part of the price charged for local service. It
18 is just as reasonable (and historically more typical) to recover some of these costs through
19 fees paid by toll carriers, as well as through prices charged for optional services like
20 Caller ID.

21
22 **Q. What is Dr. Thompson's position on this issue?**

23 **A.** Dr. Thompson appears to believe that the historic method of recovering loop costs is
24 inappropriate, and that all of these costs should be recovered from the local customer,
25 because they "cause" these costs to be incurred:
26

27 The customer's request, or anticipated request, for access to Qwest's

1 network is the reason that Qwest incurs the cost of constructing and
2 placing the loop. ... Arbitrary recovery of the loop cost from usage based
3 services has the same result as arbitrary allocation of the loop cost to, and
4 recovering it from, those services. ... The act of providing access to the
5 customer is the cause of the loop cost, so that cost should be attributed to
6 network access.
7

8 **Q. Do you agree?**

9 **A.** No. My view is that retail subscribers don't demand loops; they demand the ability to
10 make and receive telephone calls, both local and long distance, and to enjoy the various
11 ancillary services that carriers can provide. Attempts to define "dial tone access" as a
12 separate service are inconsistent with the way most customers view the services they
13 receive, as well as the historical pricing patterns within the industry. Furthermore, this
14 type of definitional gymnastics does not change the underlying economics of the
15 situation, any more than defining "cows" as the output changes the joint nature of cattle
16 feeding costs with respect to the various retail services actually demanded by customers
17 (e.g., hamburgers and leather gloves).

18 Assigning costs on the basis of a guess about the intention of ratepayers when
19 they make a purchase is not a sound basis for economic analysis. Perhaps some
20 consumers are only thinking about local calling when they arrange for a local loop to be
21 installed into their home. Undoubtedly, many more consumers want to obtain and use an
22 entire array of telecom services, including local, toll and custom calling. The fact that
23 access is bundled with local usage doesn't mean that local service alone "causes" these
24 costs. To the contrary, the loop costs are also "caused" by demand for toll and ancillary
25 services, which also play a role in motivating people to connect to the switched network.

26 Any attempt to trace "cost causation" to these individual services on the basis of
27 consumer motivation is bound to be meaningless, since the loop costs are actually
28 "caused" by the desire to use an array of different services, and the chain of causality
29 cannot be uniquely traced back to any single service within this array. If the dial tone line

1 were bundled with toll service, and local service were priced as an optional add-on, many
2 consumers would still acquire the dial tone line, to ensure that they can place and receive
3 toll calls, regardless of whether or not they ever place or receive any local calls. If the
4 loop were bundled with toll, it might appear that the dial tone line is a direct cost of toll,
5 and thus one could plausibly argue that the entire cost should be attributed to the toll
6 category. However, this type of reasoning is not economically valid, regardless of which
7 service is bundled with the dial tone line, and regardless of which service provides the
8 dominant or primary motivation for acquiring the dial tone line. So long as numerous
9 different services require the use of the line, economic theory suggests that all of these
10 different services will contribute towards the cost of the line.

11 In competitive markets, consumer motivation and "cause and effect" reasoning
12 does not have any impact on the manner in which joint costs are recovered. To the
13 contrary, all of the joint products contribute to the joint costs, with the relative
14 proportions being determined by the relative strength of demand. Cause and effect is
15 essentially irrelevant, except to the extent it reflects strength of demand. Consider, for
16 example, cotton and cotton seed. Cotton seed is a mere byproduct of the production of
17 cotton, and people buying cottonseed oil arguably don't "cause" cotton to be grown, while
18 the consumers of cotton cloth arguably do "cause" the various costs of growing raw
19 cotton to be incurred. Nevertheless, consumers of both cottonseed oil and cotton clothing
20 contribute to the cost of growing and harvesting cotton. The mere fact that the planting of
21 cotton is "caused" by demand for cotton cloth does not result in all of the joint costs being
22 recovered from the clothing market, and none from the ancillary products like cottonseed
23 oil. Customers in both markets share the joint costs, in proportions that are determined by
24 the relative strength of demand for cotton cloth and cottonseed oil.

1 **Q. In the end, doesn't Mr. Thompson agree with your view that many different services**
2 **are currently helping to recover the cost of the loop?**

3 A. Yes. On page 18 of his rebuttal testimony, Mr. Thompson states,

4
5 If my reading of his [Dr. Johnson's] testimony is correct, then it seems that
6 his issue is not necessarily with Qwest's TSLRIC studies, but rather with
7 its comparison of revenues to the TSLRIC results. In essence, in my
8 words, he seems to be emphasizing that the contribution from other
9 services, (i.e., the excess of price over TSLRIC for those services), be
10 considered as recovering the cost of the loop. If this is an accurate
11 portrayal of his view, I would not disagree that this is the current state of
12 cost recovery for Qwest in Arizona.
13

14 There seems to be no disagreement about the current situation; the disagreement concerns
15 whether or not this situation involves an inappropriate "subsidy" of local service, and/or
16 whether the trend towards competition requires a drastic change in the situation. The
17 Qwest witnesses fail to make a persuasive case on either of these points of disagreement.
18

19 *Withdrawal of Local Service*
20

21 **Q. Would you please explain Qwest's proposed "acid test" for determining whether a**
22 **particular cost is a shared cost?**

23 A. Yes. Dr. Taylor posits,

24
25 This is the acid test of a shared cost: Does the entire cost of the allegedly
26 shared facility disappear when one of the services it is claimed to support
27 is withdrawn? If the answer is "yes," then that facility cannot be shared.
28

29 In this case the "allegedly shared facility" is the loop and Dr. Taylor goes on to argue that
30 withdrawal of local service causes the loop costs to disappear.
31

1 **Q. Do you agree with his conclusion concerning this test?**

2 A. No. Loop costs would only disappear to the extent the withdrawal of local service is
3 simultaneously accompanied by a reduction or withdrawal of various other services, in
4 addition to basic exchange. Because of the way Qwest bundles the loop with basic local
5 service, if customers stop buying this service, they will necessarily also stop buying
6 Qwest's custom calling services, and carriers will no longer be able to originate and
7 terminate toll calls involving these customers.

8 The only meaningful way to formulate Dr. Taylor's "acid test" is to ask whether
9 the entire cost of the allegedly shared facility will disappear if one of the services is
10 withdrawn, assuming all other services continue to be provided to the same extent as
11 previously. In other words, in formulating his test, all other services should be held
12 constant, so that only one service is changed. Without this "*ceteris paribus*" assumption,
13 one can't know whether the cost goes away because the service in question is withdrawn
14 or reduced, or whether the costs go away because other services are simultaneously being
15 reduced.

16 By performing Dr. Taylor's "acid test" while holding all other services constant, it
17 becomes clear that local service "passes" the test. Loop costs are not direct costs of local
18 service, because these costs will continue to be incurred, even if local service is
19 withdrawn, since loops are needed to provide custom calling, switched access and other
20 services. Regardless of whether or not Qwest provides customers with the ability to place
21 and receive local calls, it needs loops in order to provide switched access and other
22 services. Thus, even if it were to eliminate local service, Qwest would continue to incur
23 loop costs, in order to continue to collect switched access and other revenues. Only by
24 cutting back or eliminating the entire family of services that use the loop would Qwest be
25 able to avoid the costs of the loop.

26 Dr. Taylor is correct when he states that loop costs cannot be avoided by
27 eliminating the provision of these ancillary services—*ceteris paribus*. But the same logic

1 applies equally well to basic service—*ceteris paribus*. Qwest would not be able to charge
2 for call waiting or Caller ID unless it provides consumers with a loop which enables them
3 to learn that a call is waiting, or to learn the identify of the party that is calling them.
4 Similarly, Qwest wouldn't be able to charge toll carriers for switched access service,
5 unless it has loops available which it can use to originate or terminate their toll traffic.
6 Thus, regardless of whether or not Qwest provides basic local service, it will necessarily
7 incur loop costs in order to provide its other services.
8

9 **Q. Would you like to add any concluding remarks to your discussion of the loop as a**
10 **joint and common cost?**

11 **A.** Yes. It is not surprising that Qwest's rate design witnesses devote a large fraction of their
12 rebuttal to this topic, since it lies at the heart of Qwest's proposals to drastically increase
13 residential local service rates. As I explained on page 61 of my direct testimony, its
14

15 ...entire presentation concerning basic exchange rates and costs depends
16 upon removing from view most of the revenues that are generated by its
17 local network, while including nearly all of the costs of that network. This
18 misleading view of costs and revenues has been presented many times
19 before in regulatory proceedings, and it has been rejected or ignored nearly
20 as often as it has been presented.
21

22 Although the rebuttal testimony is quite lengthy, it brings out no new facts, and it fails to
23 provide any hard evidence that the historic methods of recovering the loop costs are no
24 longer appropriate or sustainable. To the contrary, even Qwest itself has proposed to
25 continue aspects of its historic pricing practices, by substantially increasing rates for
26 Caller ID and premium listings. These increases are not based upon principals of cost
27 causation, but instead are based upon its belief that demand is strong enough to sustain
28 prices for these valuable services which are even higher than the existing levels.
29

1 **Competition and Pricing**

2 *TSLRIC as a Price Floor*

3
4 **Q. You mentioned in your introduction that you were concerned with Qwest's use of**
5 **TSLRIC as a price floor for service rates. Would you please outline this concern?**

6 **A. Yes. Mr. Teitzel, in responding to a portion of Mr. Dunkel's direct testimony, stated the**
7 **following:**

8
9 The competitive zone proposal would allow Qwest to package services in
10 a manner similar to what its competitors are offering which may
11 necessitate the pricing of a particular service below its TSLRIC. However,
12 as long as the total revenue for the customer or group of customers is
13 above its TSLRIC, this would be an acceptable pricing mechanism.
14 [Teitzel, Rebuttal, pp. 16-17]
15

16 When regulators have provided dominant carriers with pricing flexibility, they
17 typically place limitations on that flexibility, to protect the public interest and ensure that
18 the carrier does not abuse its discretion. Dr. Taylor, in his rebuttal testimony, alludes to
19 the benefits of such an approach, since it can prevent anti-competitive pricing:
20

21 A cost-based price also insures against anticompetitive behavior. For
22 example, a price that is no less than the underlying incremental cost cannot
23 be predatory. Also, a price that is no less than the underlying total service
24 long run incremental cost ("TSLRIC") cannot be receiving a
25 cross-subsidy. Thus, a firm that charges a price that is at least equal to
26 incremental cost or TSLRIC cannot be pricing anti-competitively. [Taylor,
27 Rebuttal, p. 65]
28

29 While Dr. Taylor gives the impression that he approves using TSLRIC as a price
30 floor, Mr. Teitzel makes it clear that Qwest wants the freedom to cut prices below this
31 floor. To put this matter into perspective, it is important to realize that a potential problem

1 exists whenever a firm that enjoys monopoly power in one market also operates in other,
2 more competitive markets. Unless precluded by regulation, the firm will have an
3 incentive to shift costs from more competitive to less competitive services, to overprice
4 its less competitive services, and/or to underprice its more competitive services. A
5 generic term for these practices, including those which fall within the strict definition of
6 "cross-subsidization" and those which do not, is "anticompetitive pricing." Essentially,
7 this term indicates that an integrated firm is strategically pricing its services in order to
8 take advantage of the market power it enjoys in the less competitive markets. The goal of
9 this strategic pricing behavior may include deterring entry, gaining a competitive
10 advantage, or maintaining a dominant share of markets which potentially could become
11 more competitive, absent the pricing strategy.

12
13 **Q. Does the Commission need to be concerned about the possibility of anti-competitive**
14 **pricing behavior by Qwest?**

15 **A.** Yes. As long as Qwest remains vertically integrated and maintains a mixture of
16 competitive and monopoly operations, it will have an economic incentive to engage in
17 anticompetitive pricing. During the current transition period, and for an indefinite period
18 thereafter, the Commission needs to adapt its regulatory policies in ways that effectively
19 deal with these incentives. It should not simply assume that anticompetitive behavior
20 won't occur, nor should it assume that the anti-trust laws are sufficient to protect the
21 public interest.

22 The majority of such anticompetitive behavior is price related, including the
23 pricing of competitive services at unreasonably low levels (competitive underpricing), the
24 use of revenues from less competitive services to financially support, or cross-subsidize,
25 more competitive services, and the overpricing of bottleneck services, including those
26 used by competitors.

27 As I have pointed out in earlier portions of my testimony, the Commission should

1 be very cautious about granting increased pricing flexibility. While some degree of
2 increased flexibility may be merited as competition intensifies, it is important to impose
3 appropriate constraints, to ensure that Qwest does not thwart the trend towards increased
4 competition, or otherwise engage in anti-competitive pricing practices that are harmful to
5 the public interest.

6
7 *Rule Changes*

8
9 **Q. Let's turn to Qwest's criticism of your proposed revisions to the Commission's rules.**
10 **What was Qwest's response to your proposed changes?**

11 **A.** Mr. Teitzel disagrees with my proposal, apparently because he feels they are unnecessary.
12 In my direct testimony, I recommended modifying Rule 14-2-1108(A) to allow the
13 Company to petition for competitive classification of services within a specific market,
14 rather than statewide. The rule would read as follows:

15
16 A telecommunications company may petition the Commission to classify
17 as competitive, within a specified relevant market, any service or group of
18 services provided by the company. The telecommunications company shall
19 file with the Docket Control Center ten (10) copies of its petition. The
20 telecommunications company also shall provide notice of its application to
21 each of its customers within the specified relevant market, if any, and to
22 each regulated telecommunications company that serves the same
23 geographic area or provides the same service or group of services, or a
24 service or group of services similar to the service or group of services for
25 which the competitive classification is requested.
26

27 My proposed additions to rule 14-2-1108(A) would make it clear that pricing flexibility
28 can be granted on a geographically specific basis. Mr. Teitzel apparently believes this
29 option already exists, based upon the definition of a "relevant market" which is already
30 contained in the Commission's rules:

1 Where buyers and sellers of a specific service or product, or of a group of
2 services or products, come together to engage in transactions. For
3 telecommunications services, the relevant market may be identified on a
4 service-by-service basis, a group basis, and/or by geographic location. [R-
5 14-2-1102, A.A.C.]
6

7 Mr. Teitzel relies upon the fact that the Commission's rules already contain this definition
8 of a "relevant market," yet this term is never mentioned in the rule which allows the
9 Company to petition for competitive classification. The change which I am proposing
10 would incorporate this existing definition into the rule concerning competitive
11 classification, thereby clearly stating that services may be declared competitive within
12 limited geographic areas, or for specific groups of customers.

13 As it currently exists, the rule indicates that a carrier can request competitive
14 classification for a "service" or "group of services." The existing rule does not state that a
15 request for competitive classification can be directed at limited group of customers, or a
16 limited geographic area. Nor does the rule provide any indication that such a request can
17 encompass anything less than an entire service or group of services. Thus, if a service is
18 provided statewide, the existing rule does not explicitly contemplate the possibility that a
19 carrier might seek to declare it to be competitive within some parts of the state, and not
20 within others.

21
22 **Q. If Mr. Teitzel is right, and the existing rules give Qwest the right to request pricing**
23 **flexibility in specific geographic locations, why hasn't the Company submitted such**
24 **a petition under the existing rule?**

25 **A.** That is a good question, but the answer isn't obvious to me. Since Qwest claims to be
26 anxious to gain increased pricing flexibility in the geographic areas where competition is
27 the most intense, it would seem logical to seek this relief under the existing rule, if that is
28 permissible under the existing rule. Why has it instead submitted a proposal that
29 seemingly falls outside the scope of the existing rule, within the context of this lengthy

1 and complex proceeding?

2 In fact, given Mr. Teitzel's interpretation of the existing rule, it isn't entirely clear
3 to me what is the intended purpose of the Company's request in this proceeding. Mr.
4 Tetizel states that my proposed rule changes "will not result in affording Qwest the
5 pricing flexibility it needs to respond to competition where it is occurring". [Teitzel
6 Rebuttal, p. 68]. But how does my recommendation fall short of what it claims it needs?
7 One possible difference is that under the existing rule (even as modified by my proposed
8 wording change), Qwest's request would be subject to investigation, and it must prove
9 that competition is sufficiently intense to justify the relief which is sought. Arguably, this
10 is different than the Company's proposal in this proceeding, in which it seeks greatly
11 increased pricing freedom due to the mere presence of competitive alternatives, regardless
12 of how weak that competition may be. Perhaps that is the significance of Mr. Teitzel's
13 explanation that under its proposal in this proceeding "Qwest will have the burden of
14 demonstrating to the Commission that competition exists", and that the Commission "will
15 have the opportunity to object to Qwest's proposal and initiate a formal investigation."
16 [Id., p. 57]. Since an investigation is permissible in either case, the main difference may
17 be that Qwest wants to only be required to show that competition "exists" without having
18 to show how intense that competition is, or to show that its market power has diminished
19 significantly.

20 Under the existing rule, Qwest already has the right to petition for competitive
21 classification of a service or group of services, but this classification probably won't be
22 granted unless a Commission investigation confirms that the service is, in fact, subject to
23 substantial competition.
24

Market Share

Q. How does Dr. Taylor react to claims that Qwest hasn't lost sufficient market power to justify increased pricing flexibility?

A. Dr. Taylor argues that other witnesses have "incorrectly" emphasized market share when evaluating the merits of Qwest's competitive zone proposal. [Taylor, Rebuttal, p. 37]. According to Dr. Taylor, market share is only a "supporting statistic", and is not a sufficient indicator of the status of competition. Further, Dr. Taylor argues that alternative indicators, such as "capacity", are more relevant than the access line data relied upon by other parties.

Q. Do you agree that market share should be "de-emphasized" when judging the merits of Qwest's proposal?

A. No. Dr. Taylor recognizes the importance of market power, but he suggests that market share is not a good indicator of the presence or absence of market power. [Id., pp. 46-47]. I strongly disagree. While other evidence can potentially be useful, market share data is by far the single most important form of evidence that the Commission can consider in evaluating the actual extent to which a dominant carrier is actually losing its market power.

A widely accepted measure of market power is the Lerner Index, named after the renowned economist Abba Lerner. As applied to a monopolist, the formula deriving the index contains no market share term, since that market share is, by definition, 100%. Instead, the index focuses on the relationship between price, marginal cost, and elasticity of demand. In general, market power is greatest where price exceeds marginal cost by a wide margin and the elasticity of demand is low:

1 $L_i = (P - MC) / P = 1 / e_i^d$, where

2 L_i Lerner index

3 P price

4 MC marginal cost

5 e_i^d elasticity of demand

6
7 Elasticity of demand is defined as the percent reduction in quantity demanded
8 resulting from a price change divided by the percent increase in the price. The lower the
9 elasticity of demand, the better a firm is able to increase prices to achieve higher profits.

10 Applied to the more complex situation of a dominant firm operating with lesser
11 competitors, the equation contains factors not only for price elasticity of demand for the
12 dominant firm, but also market share for the dominant firm (which can be expressed as 1
13 - shares of other firms), market demand elasticity, and elasticity of supply of the
14 competitive fringe.

15
16 $L_i = 1 / e_i^d = S_i / [e_M^d + e_f^s (1 - S_i)]$

17 L_i Lerner index

18 e_i^d Price elasticity of demand for the dominant firm

19 S_i Market share for the dominant firm

20 e_M^d Market demand elasticity

21 e_f^s Elasticity of supply of the competitive fringe

22
23 In this form the Lerner Index equation is directly relevant to the question of
24 whether or not market share data is important in gauging the existence of market power.
25 As reflected by the equation, the larger the market share of the dominant firm, the greater
26 the incumbent's market power. All other factors held constant, market power varies
27 directly with the incumbent's market share--that is, the higher the incumbent's market

1 share, the greater the Lerner Index and thus the incumbent's market power and its ability
2 to control price. It is certainly true that other factors (e.g. demand elasticity) are also
3 relevant, but not to the exclusion of market share. As economist Michael Utton states,
4 "The emphasis antitrust authorities have placed on market share is well founded."
5

6 **Q. Would increased pricing freedom help Qwest retain its existing market power?**

7 A. Absolutely. Qwest's market power will decline as its market share declines. But if Qwest
8 is essentially given *carte blanche* to modify prices at will in specific markets across the
9 state, Qwest can use its existing market power to selectively cut prices in response to
10 competitive inroads, it can raise prices and profits in markets where entry barriers are the
11 highest, and it can engage in a variety of different pricing strategies designed to slow the
12 erosion of its market share.

13 Given a choice between competing in a state where the incumbent has been
14 largely deregulated and one where the incumbent is subject to traditional prohibitions
15 against discriminatory pricing practices, new carriers would logically find the latter
16 market more attractive. In a sense, then, granting Qwest's competitive zone proposal
17 could tend to discourage entry into Arizona markets—particularly if other states are slower
18 in granting broad pricing freedom and they continue to play a more active role in
19 discouraging or prohibiting anti-competitive pricing practices.
20

21 **Q. Do you agree that capacity is an appropriate factor to consider in evaluating market**
22 **power?**

23 A. Yes. As I just mentioned, the Lerner index confirms that the elasticity of supply from
24 other firms is an important consideration in evaluating Qwest's marker power. However,
25 Dr. Taylor goes too far when he argues that measuring capacity or the stock of productive
26 facilities instead of market share gives a "more reliable predictor of the firm's future
27 (strategic) behavior". [Id., p. 40]. The capacity of other carriers' networks is certainly

1 relevant, but only to the extent this capacity can readily be applied to serving customers
2 in the market in question. If a competing carrier has installed fiber optic cable in the
3 downtown Phoenix area, this probably has very little relevance to most of Qwest's
4 residential markets.

5 Facilities which aren't in the right physical location to serve particular markets
6 won't have much, if any, impact on the elasticity of supply available to serve those
7 markets. Similarly, facilities which are costly to operate, or which don't have the right
8 technical characteristics to optimally serve particular markets, won't contribute much to
9 the elasticity of supply applicable to those markets. Thus, for example, SONET fiber
10 systems which are well suited to the needs of large business customers may theoretically
11 be capable of serving residential customers, but that theoretical capability isn't
12 necessarily very relevant. In evaluating competitive market conditions, one must evaluate
13 potential capacity in light of how quickly and cost-effectively that capacity can be
14 adapted to meet the needs of the particular market in question.

15 Dr. Taylor concludes that rather than focusing on market share, the Commission
16 should "examine whether indicators of market power (e.g., capacity) are present in each
17 of the wire center markets for which Qwest is seeking a competitive zone declaration".
18 [Id., p. 47]. While I have no objection to his suggestion that the Commission should
19 examine more than just market share, I strongly disagree with the notion that these other
20 factors are more important than market share, or that a simple measure of network
21 capacity can be very useful. To the extent one is going to consider data concerning
22 competitive networks, one must consider not only the size of those networks, but also the
23 extent to which various factors make it difficult or impossible for the owners of those
24 networks to use their facilities to serve additional customers. If there are geographic,
25 technical or economic constraints which make it difficult for a carrier to serve additional
26 customers, these factors ought to be considered. Similarly, if there are factors which
27 discourage customers from changing suppliers, this should also be considered.

1 In any event, it is important to realize that Qwest has not offered any substantial
2 evidence concerning the factors cited by Dr. Taylor. For instance, the record in this
3 proceeding doesn't reveal Qwest's "capacity" to serve any of the markets it seeks to
4 declare as "competitive," nor does the record provide any detailed evidence concerning
5 the capacity of competing carriers.
6

7 **Q. Let's turn to Mr. Teitzel's criticism of your market share analysis. He claims that**
8 **you failed to consider the market share of Arizona CLECs and that you assumed**
9 **that only competition for high capacity services exists. Are these valid criticisms?**

10 **A.** No. I incorporated into my analysis an allowance for the share of the market served by all
11 types of competitive carriers, including Cox Cable and other facilities-based CLECs. In
12 developing my estimates, I relied upon my 25 years of experience in this industry, as well
13 as a careful interpretation of the limited amount of data provided by Qwest in this
14 proceeding. For example, Qwest provided number portability data which was helpful in
15 gauging the extent of competition from facilities-based carriers. Also, I took into
16 consideration my general knowledge of competitive trends in the industry, which I have
17 acquired as a result of my involvement in proceedings in other jurisdictions.
18

19 **Q. Do you agree that a more complete and accurate picture of competitive market**
20 **conditions could be developed if the Commission required the CLECs to provide**
21 **data concerning their market shares?**

22 **A.** Yes. While I believe my market share estimates are adequate to demonstrate that Qwest's
23 competitive zone proposal should be rejected, I recognize that the trend towards increased
24 competition is continuing. At some point in the not too-distant future a legitimate
25 question may arise concerning whether competitive inroads have been sufficient to justify
26 giving Qwest greater pricing flexibility. In dealing with such a situation, it would be
27 preferable to obtain and rely upon more complete, detailed market share information. The

Commission has the authority to subpoena CLECs for this information, or to establish a rule which requires all CLECs to routinely report information concerning the number of lines they serve, and the amount of revenue they generate in particular markets.

Q. Are you familiar with any situations in which CLECs were required to provide data concerning their market shares?

A. Yes. In Docket No. P-00971307, Bell Atlantic-PA filed a petition requesting a determination that all business telecommunications services in Pennsylvania were competitive. During the course of the proceeding, a dispute arose concerning the extent to which CLECs had gained market share in the state. Like Qwest in this proceeding, BA-PA argued that market share data could not adequately be evaluated without obtaining detailed information from its competitors. It applied to the Administrative Law Judge ("ALJ") for subpoenas for the production of documents regarding the market shares of all Pennsylvania CLECs, including carriers who were not parties to the Pennsylvania proceeding. [Recommended Final Order, pp. 2-3]. BA-PA's request was granted, and 60 to 70 subpoenas were issued to CLECs concerning their Pennsylvania operations. [Id., p. 21].

Q. Did the subpoenaed data provide a significantly different picture of the actual status of competition in that state?

A. No, not to my knowledge. Only one CLEC objected to the subpoena, and even this carrier eventually provided at least some of the evidence ordered by the ALJ. Nevertheless, Bell Atlantic chose not to submit testimony and exhibits showing market shares derived from the response to its subpoenas. The ALJ concluded that Bell Atlantic's failure to rely upon or present any of the subpoenaed data was, by itself, evidence of the lack of competition. [Id., p. 21]. Rather than present market share data, Bell Atlantic, through the testimony of Dr. Taylor and other witnesses, attempted to divert attention away from actual market

1 shares, by focusing on CLEC growth rates and claims that competitors could rapidly enter
2 the market if it raised its prices. The ALJ concluded that

3
4 while all of these factors are interesting, and perhaps entitled to some
5 weight, they are not substitutes for data regarding the extent to which
6 competitors are actually rendering service to different kinds of business
7 customers in different areas of BA-PA's service territory. [Recommended
8 Final Order, p. 18].
9

10 Similarly, in this proceeding, the types of anecdotal evidence offered by Qwest
11 concerning the marketing activities and potential "capacity" of competitors, while
12 interesting, are not adequate substitutes for hard evidence concerning the actual status of
13 competition in Arizona. In future proceedings, if there is any question in the
14 Commission's mind concerning the extent to which competitive pressures have
15 intensified, it should require Qwest and other carriers to provide detailed information
16 concerning the number of lines they serve, and the revenues they generate, in particular
17 parts of the state.
18

19 **Q. You seem to be suggesting the need for further proceedings after the conclusion of**
20 **this docket. Hasn't Qwest objected to such an approach?**

21 **A. Mr. Teitzel states that**

22
23 the Company is seeking a means of being able to effectively respond to
24 competition without subjecting the Arizona Commission and ratepayers to
25 a lengthy regulatory proceeding. A one to two year proceeding to
26 determine if a particular geographic area is subject to competition is the
27 antithesis of a competitive environment. [Teitzel, Rebuttal, p. 58].
28

29 I'm not sure if he is objecting to the prospect of any further regulatory investigations
30 beyond this proceeding, or if he is only complaining about the prospect of extended one
31 to two year proceedings for each of the 39 geographic areas Qwest wants declared

1 competitive zones. If it is the latter, I certainly agree with him. It would not be a wise use
2 of resources to complete 39 different proceedings--nor do I think this would be necessary.

3 While Qwest hasn't yet made a convincing case that it faces substantial
4 competition in any of these 39 wire centers, this does not preclude the possibility that
5 conditions may change, or that Qwest might be able to make a persuasive case for
6 increased pricing flexibility given some additional effort. While I don't think it will be
7 necessary for the Commission to undertake a lengthy fact finding effort each time Qwest
8 wants to classify another wire center or another service as competitive, it certainly needs
9 better information to evaluate such proposals than what Qwest has volunteered in this
10 proceeding.

11 A practical approach would be for Qwest to work with the Staff and RUCO in
12 identifying a small group of markets which it considers to be the most intensely
13 competitive, where it believes its market share has declined the most sharply, and where
14 it feels greater pricing flexibility is most strongly justified. The Commission would then
15 work with Qwest and other interested parties in gathering the data necessary to evaluate
16 market shares and other indicators of the extent of actual competition in the selected
17 markets. Depending upon the outcome of that proceeding, the Commission might provide
18 Qwest with additional pricing flexibility in some or all of the selected markets (though I
19 question whether it would be appropriate or necessary to provide the extreme level of
20 flexibility Qwest has sought in this case). As experience is gained with evaluating the
21 most important factors (e.g. market shares), it should be feasible to implement a more
22 streamlined and automated approach to use in evaluating other requests. As experience is
23 gained, it might well be possible to identify "triggers" which would result in an
24 appropriate increase in pricing flexibility, without the necessity for a lengthy, fully
25 litigated proceeding in every case.
26
27



1 **Q. Do you have any further comments concerning Qwest's view of competition?**

2 A. Yes. Qwest has asked the Commission to virtually deregulate it within much of the state.
3 It has also asked for an increase in basic residential local rates, decreases in access and
4 toll rates, and increases to a whole host of ancillary services like premium listings and
5 Caller ID where competitive pressures are presumably weakest. The underlying rationale
6 for these proposals seems to be Qwest's view of the competitive climate in the state:

7
8 ...competition is thriving, consumers in Phoenix and Tucson have choices
9 in telephone providers, and consequently, reduced regulation of Qwest's
10 services in those areas targeted by competitors is an appropriate
11 Commission response. [Teitzel, Rebuttal, pp. 39-40]
12

13 It would surprise me if Qwest were not losing market share, nor experiencing any
14 downward pressure on its profits. But, if the pressures were very substantial, I expect
15 Qwest would have volunteered more hard data concerning actual market conditions, and
16 it would have relied much less upon broad generalities, vague references to "thriving
17 competition," copies of competitors' marketing materials, and the like. Perhaps Qwest
18 has been operating in a quasi-monopoly environment for so long, it fails to see how the
19 current transition period, in which some competitors have entered the market and are
20 starting to gain a toehold, dramatically differs from a truly competitive environment—one
21 in which competition is so intense, it greatly constrains or eliminates the incumbent
22 carrier's market power.
23

24 **Q. Are there indications within Qwest's own pricing proposals that competition is not
25 yet strong enough to constrain its market power?**

26 A. Yes. Mr. Teitzel and I both agree that once competition becomes intense, it will reduce
27 the dominant carrier's ability to extract extremely large profit margins from high revenue
28 customers. Within the residential category, the highest revenues (and profit margins) are
29 generated by customers that opt for features like Caller ID. Although the perceived value

1 of these features can be very high, the marginal cost of providing them is generally very
2 small—certainly less than \$0.20 per month, and sometimes as little as a few pennies per
3 month. For example, Caller ID typically utilizes software which already resides in the
4 switch. Virtually the only additional costs which are incurred when this service is “turned
5 on” for a particular customer is the extra paper and ink required to list the price on the
6 monthly bill, and a minuscule amount of data processing capacity which is used to check
7 the number against a data base of names, and to forward this information to the customer.

8 In this proceeding Qwest proposes to increase the price it charges for Caller ID to
9 \$6.95 per month. As I discussed earlier, a widely accepted measure of market power is
10 the Lerner Index. In the case of Caller ID, the existing price vastly exceeds marginal cost,
11 suggesting a Lerner Index value which is consistent with a very high degree of market
12 power. Qwest’s proposal to increase this price even farther above marginal cost suggests
13 that its market power remains strong, and that it isn’t particularly worried about irritating
14 its most lucrative residential customers, or stimulating them to begin looking for a
15 competitive alternative.

16
17 **Q. You mentioned earlier that the Commission could gather data from competitive**
18 **carriers concerning their market shares. Have any other regulatory agencies**
19 **collected data of this type?**

20 **A.** Yes. The FCC collects data from both incumbent and competitive carriers, which it
21 recently published in its annual Local Telephone Competition Report. As one would
22 expect, the report confirms the existence of a trend towards increased competition in most
23 local markets. The report also confirms that incumbent carriers continue to dominate
24 those markets.

25 The data included in this report is generally consistent with the conclusions I
26 reached in my direct testimony. For instance, Table 4 of the report shows CLECs serving
27 125,991 residence and business end-user lines in Arizona. According to ARMIS data

1 published by the FCC, the ILECs filing ARMIS data for Arizona (US West and GTE of
2 California) served a total of 2,870,384 end-user lines in 1999, with virtually all of these
3 lines being reported by US West including (2,861,742). Comparing the data in these two
4 FCC reports, it is apparent that CLECs serve a relatively small portion of the overall
5 market—less than 5%.

6 This picture is not unlike what can be seen in the nation as a whole. According to
7 the FCC's Local Telephone Competition Report, CLECs serve less than 5% of the nearly
8 190 million end user lines in service in the United States. Similarly, ILECs obtained
9 94.2% of reported revenues from local service in 1999. Thus, regardless of whether
10 market shares are calculated in terms of lines or revenues, it is clear that ILECs continue
11 to dominate local markets throughout the country.
12

13 **Q. As competition intensifies, would you expect competitors to cut prices, in an effort to**
14 **gain residential market share?**

15 **A.** Yes. A good example is in the Pittsburgh, Pennsylvania area, where AT&T has begun to
16 offer telephone service over the cable television systems it acquired from TCI. AT&T's
17 tariff includes "Basic Local Only" rates of \$10.25 and "Local Only" rates of \$20.95 or
18 \$25.95 for one line, depending upon geographic location. "Local Only" differs from
19 "Basic Local Only" in that "Local Only" includes Call Waiting, Caller ID Deluxe and
20 Three Way Calling. The gap between AT&T's rates in Pittsburgh and those proposed by
21 Qwest for Phoenix is even larger than it might appear at first glance, because Qwest also
22 imposes an "End User Line Charge" of at least \$4.35 per month, (authorized by the
23 Federal Communications Commission), whereas AT&T does not. Thus, Qwest's current
24 and proposed rates are \$17.53 and \$20.03, respectively, for the equivalent level of service
25 included in AT&T's "Basic Local Only" rate of \$10.25 per month. Similarly, Qwest's
26 current and proposed rates are \$31.98 and \$35.48 for the equivalent level of service
27 included in AT&T's "Local Only" rates of \$20.95 inside the Metro area and \$25.95 per

1 month outside the Metro area.

2
3 **Rate Design**
4

5 **Q. How has Qwest responded to your specific rate design recommendations?**

6 A. In response to the extensive analysis I put forward in my direct testimony, Mr. Teitzel has
7 offered just a few general responses. Two of these merely rehash points I have already
8 discussed, while the third critiques the toll volume adjustment I proposed.
9

10 **Q. Would you please discuss the first of Mr. Teitzel's responses?**

11 A. Yes. Mr. Teitzel's only response to my specific recommendations and analysis regarding
12 basic local service was a general reference to the shared cost debate. He contends that
13 since my "presumptions regarding cost allocation and absence of residential local
14 exchange subsidy are incorrect," my recommendations should be disregarded in their
15 entirety.

16 At this point, I imagine the Commission may be a little weary of the "Is not!" "Is
17 too!" verbal tennis match concerning this issue, so I will not comment further concerning
18 the merits of this claim. Instead, I would simply point out that Qwest has ignored many
19 elements of my reasoning, and it hasn't provided any response to various portions of my
20 testimony which are not dependent upon my view of the subsidy issue. For example,
21 Qwest has not responded to my concern that the proposed local rate increases are too
22 extreme, or my contentions that these increases violate the principal of rate continuity,
23 they place an undue burden on consumers, and they will push thousands of customers off
24 the network, contrary to the goal of universal service.

1
2 **Q. Would you please discuss the second of Mr. Teitzel's responses to your pricing**
3 **proposals?**

4 **A.** Yes. On page 69 of his rebuttal testimony, Mr. Teitzel states,

5
6 Qwest's zone increment proposal establishes rate levels that are
7 appropriately in alignment with Qwest's pending proposal regarding
8 deaveraged UNE loop prices. Failure to align the retail and wholesale
9 prices outside the Base Rate Area in Arizona will create significant
10 pricing anomalies and potential for rate arbitrage. Qwest's proposal is
11 entirely reasonable. [Teitzel, Rebuttal, p. 69]

12
13 Qwest's zone increment proposal may indeed be in alignment with Qwest's deaveraged
14 loop proposal, but that fact alone does not negate the many concerns I expressed in my
15 direct testimony. In fact, the Commission's most recent order in docket T-00000A-00-
16 0194 granting Qwest the authority to deaverage its UNE loop rates lends further credence
17 to my original reasoning.

18 In Decision No. 62753, the Commission found that "Staff and AT&T have
19 presented plans that reflect actual costs better than the US West proposal." Thus, the
20 Commission didn't necessarily agree with the loop cost analysis which Qwest relied upon
21 in this proceeding. The deaveraged loop rates approved by the Commission are lower for
22 each zone than those put forward by Qwest in this proceeding. Inside BRA rates were
23 approved at \$18.96 as opposed to \$20.12. Zone 1 rates were approved at \$34.94 as
24 opposed to \$40.65. Finally, Zone 2 rates were approved at \$56.53 as opposed to the
25 \$63.70 outlined in Mr. Teitzel's supplemental direct testimony. Using these loop cost
26 figures, the contribution to joint and common costs which are generated by the existing
27 and proposed local service rates are higher than the analogous contribution rates I
28 developed in my direct testimony, based upon the Qwest cost figures. This updated
29 information further negates the need for drastic increases in residential local exchange
30 rates, or the zone increment charges.

1 In Decision No. 62753, the Commission emphasized one of the points I made
2 throughout my testimonies—the need for rate continuity, and the need for gradualism
3 where rate design changes are warranted. In its final opinion and order, the Commission
4 stated as follows:

5
6 However, those deaveraged rates should be based on the current retail
7 zone structure and not the zone structure proposed by US West in its
8 current rate case. Instead of expanding the current retail zone structure in
9 the upcoming US West rate case, it would be more appropriate to begin to
10 gradually make the rate structure more cost based. [Opinion and Order,
11 July 25, 2000, pp. 5-6]
12

13 The mere fact that competition is beginning to emerge in the local market does not justify
14 sweeping rate changes like the ones proposed by Qwest in this proceeding. To the extent
15 changes are warranted, the modifications should gradually move rates in the right
16 direction. Abrupt changes, like the proposed ten- and five-fold increases in the zone
17 increment charges, are clearly inappropriate and should be rejected.
18

19 **Q. Let's turn to Mr. Teitzel's discussion of toll elasticities. What is his response to your**
20 **conclusion that reductions in Qwest's toll prices will result in increased toll**
21 **volumes?**

22 **A. Mr. Teitzel claims that "Qwest has not experienced Toll call volume increases in**
23 **response to Toll price decreases" although he acknowledges that, prior to toll**
24 **competition, "the effects of price elasticity could be seen in demand for Toll." [Teitzel**
25 **Rebuttal, p. 25] He attempts to reconcile these two points by noting that the "toll market**
26 **is no longer a monopoly market", and therefore, Qwest's proposed toll decreases "will**
27 **not generate new demand for Qwest Toll, but will reduce the rate of erosion of Qwest**
28 **Toll minutes to competitors". [Id.].**
29

1 **Q. Do you agree with Mr. Teitzel?**

2 A. No. There are two reasons why toll price reductions will tend to stimulate increased toll
3 volumes. First, as customers experience reductions in toll rates, they will be encouraged
4 to place additional toll calls, and to talk longer. Second, as Qwest's toll prices decline
5 relative to those charged by other carriers, its customers will be given less incentive to
6 "shop around" or to consider switching to another carrier, and customers who have
7 changed to another carrier will be encouraged to consider returning to Qwest. For both of
8 these reasons, it is reasonable to assume that a toll price reduction will result in larger toll
9 volumes. The effect of competition is to increase the importance of price in determining a
10 particular carrier's toll volumes—not to reduce the importance of this phenomena. As to
11 his argument that Qwest has been losing market share to other toll carriers, this is
12 undoubtedly true. However, it is also true that overall long distance calling volumes have
13 been increasing. While Qwest's share of this market may be declining, that doesn't
14 necessarily suggest that its toll volumes have been declining. Even if it has experienced
15 some declines in absolute toll traffic, that doesn't necessarily mean that the decline will
16 continue. Thus, the effect of the toll price reductions may be to arrest the decline in
17 market share and reverse any decline in absolute volumes. Finally, I would note that if the
18 Commission were going to try to take into account any alleged decline in Qwest's toll
19 since the test year, it would also be appropriate to recognize the offsetting increase in
20 switched access traffic. As customers switch from Qwest to other toll carriers, those
21 carriers tend to increase their usage of Qwest's switched access service, resulting in an
22 offsetting increase in revenues.

23 In my opinion, an adjustment for increased toll volume would be appropriate, if
24 the Commission concludes that a reduction in toll rates is warranted. Even in a monopoly
25 market, drastic price changes can affect demand. As the market becomes more
26 competitive, price changes by any one firm will result in even greater changes in
27 volumes, as customers consider the option of changing to an alternative supplier. In my

1 direct testimony, I recommending using a toll elasticity of at least .5, which is very
2 conservative.

3
4 **Q. In your direct testimony you indicated that you might expand your Schedule 5 to**
5 **illustrate your rate design recommendations assuming a smaller overall revenue**
6 **requirement, consistent with the testimony of RUCO witness Ralph Smith. Have you**
7 **accomplished this?**

8 **A.** Yes. The version of Schedule 5 which was attached to my direct testimony illustrated my
9 rate design recommendations based upon the Company's requested revenue increase.
10 However, as explained by Mr. Smith, RUCO does not believe a revenue increase of that
11 magnitude is warranted. To the contrary, it is RUCO's belief that Qwest is currently
12 earning more than its cost of capital, and that a substantial revenue reduction would be
13 appropriate. Accordingly, I have expanded Schedule 5 to illustrate the effect of my rate
14 design recommendations assuming an overall revenue decrease of \$26 million per year.
15 My general approach is similar to the one I originally used in preparing my original
16 illustration. As before, for illustrative purposes I assumed that many of the Company's
17 miscellaneous rate proposals (both increases and decreases) would be accepted. Similarly,
18 I again scaled back the proposed zone rate increases to a more reasonable level. While I
19 agree that the zone rates should be increased, the Company's proposal is too extreme.

20 There are three major differences between my original calculations and my new
21 calculations. First, in my earlier calculations I eliminated Qwest's proposed switched
22 access rate reductions. In my new calculations, I have assumed these will be adopted. As
23 I indicated in my direct testimony, I don't believe switched access rate reductions are
24 necessary. However, in the context of a \$26 million overall revenue decrease it would be
25 reasonable to reduce these rates, consistent with the Company's proposal. Second, in the
26 context of a \$26 million annual revenue decrease, it would be appropriate to reduce basic
27 local exchange rates for both business and residence customers. In my illustrative

1 calculations, I reduced business rates by \$5.00 and I reduced residence rates by \$2.00 per
2 month. This is consistent with my revenue/cost calculations, which suggest that it would
3 be reasonable to reduce business rates by somewhat more than residence rates.

4
5 **Q. Does this complete your direct testimony, which was prefiled on September 8, 2000?**

6 **A. Yes, it does.**
7